

SEC FLASH REPORT

SEC Finalizes Guidance on Management's Assessment of Internal Control Over Financial Reporting

May 23, 2007

Today, the Securities and Exchange Commission (SEC) agreed to publish in final form the interpretive guidance for management regarding its evaluation and assessment of internal control over financial reporting (ICFR). Based on the comments received, the SEC staff recommended that the guidance be issued as an interpretation (as opposed to a rule) so that it can be more easily modified and enhanced over time.

In addition to the interpretive guidance, the SEC approved the following actions:

- (1) Adopt amendments to Exchange Act Rules 13a-15(c) and 15d-15(c) that would make it clear that an evaluation that complies with the Commission's interpretive guidance would satisfy the annual management evaluation required by those rules. The SEC staff observed that there are many ways to conduct an evaluation of ICFR. The purpose of this amendment is to make it clear that an evaluation conducted in accordance with the interpretive guidance would satisfy the requirements of Section 404. The staff also observed that some companies have already achieved compliance in prior years in other ways. Accordingly, there is no requirement for companies to align their compliance process with the interpretive guidance.
- (2) Adopt amendments to Rules 1-02(a)(2) and 2-02(f) of Regulation S-X to require the expression of a single opinion directly on the effectiveness of ICFR by the auditor in the attestation report. This amendment officially eliminates the separate auditor opinion on management's assessment process.
- (3) Adopt amendments to Exchange Act Rule 12b-2 and Rule 1-02 of Regulation S-X to define the term, "material weakness." The SEC defines a material weakness as "a deficiency, or combination of deficiencies, in ICFR such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis." The SEC staff stated that they expected the PCAOB to adopt this definition.
- (4) Propose an amendment to Exchange Act Rule 12b-2 and Rule 1-02 of Regulation S-X to define the term, "significant deficiency." Many commenters asked that the SEC define this term. The PCAOB defined the term in its proposed revisions to its auditing standard, but the SEC did not in its proposed guidance to management. To preclude management from having to look up the definition in an auditing standard and in view of the Section 302 requirement that certifying officers disclose material weaknesses and significant deficiencies to the audit committee and the auditor, the SEC has agreed to define the term. The Commission intends to begin the process by issuing a proposal for public comment. Interestingly, the SEC's proposed definition will state that a significant deficiency is one that is "less than material yet important enough to merit attention by those responsible for

oversight of the company's financial reporting." Therefore, the proposed definition will apparently not include a probability threshold and will focus exclusively on severity.

The SEC Chief Accountant, Conrad Hewitt, stated that an overall objective of these actions is to foster the preparation of reliable financial statements and to bring forth more timely information on material weaknesses into public view. Mr. Hewitt stated that the Commission's guidance provides management a principles-based approach to achieve their assessment efficiently and effectively. He observed that this balance in efficiency and effectiveness will be especially important for smaller companies who have not yet conducted an evaluation of their ICFR. The guidance should be used by these and other companies to address their own unique facts and circumstances.

In addition, during today's meeting, the Commission concluded that it would not extend further the deadline for non-accelerated filers to comply with Section 404. Therefore, such filers must comply in accordance with the deadline currently required by the extension issued last December. That extension provides that non-accelerated filers, domestic and foreign, file an unaudited internal control report in their annual reports for fiscal years ended on or after December 15, 2007. The auditor attestation for non-accelerated filers is not required until the following year. Reference is made to the Protiviti SEC Flash Report dated December 15, 2006, *SEC Grants Further Relief From the Section 404 Requirements to Smaller Companies and Newly Public Companies*, available on www.protiviti.com, for further information on these filing requirements.

The Chairman's Opening Comments

In Chairman Christopher Cox's opening comments, he pointed out that, over a year ago, the Commission and PCAOB announced a roadmap to achieve a more cost-effective and efficient approach to Section 404 compliance that directs a sharper "focus [of] management's attention on those financial controls presenting the greatest risk." Last December, the Commission proposed guidance for management¹. Concurrently, the PCAOB proposed an extensive revision of its existing Auditing Standard No. 2 (AS2). Chairman Cox stated that the SEC staff and PCAOB staff have worked together closely to bring this process to a conclusion, signaling that tomorrow's PCAOB meeting would result in final revisions to AS2. He also stated that the Commission's goal was to affect the 2007 audit cycle and that he expects the collective effort on the part of the SEC and PCAOB staffs will "positively and significantly affect Section 404 compliance for calendar 2007."

Chairman Cox asserted that Sarbanes-Oxley has increased investor confidence and that the disclosures required by Section 404 about the effectiveness of ICFR are necessary and intended for companies of all sizes. However, he also pointed out that Congress never intended that Section 404 be inflexible, burdensome and wasteful. The Congressional objective was to supply meaningful information to investors without wasting resources. The SEC guidance for management is intended to "right size" the compliance process for companies of all sizes while, at the same time, benefit investors by reducing, with emphasis on eliminating, unnecessary compliance costs. While the

¹ Reference is made to the two Flash Reports dated December 13, 2006, *SEC Proposes Interpretive Guidance on Management's Internal Control Evaluation and a Change to the Auditor Attestation*, and December 26, 2006, *The SEC's Proposed Interpretive Guidance on Management's Internal Control Evaluation – A Briefing*. Both of these Flash Reports cover the specifics of the SEC's proposed guidance and are available on www.protiviti.com.

guidance will help companies of all sizes, Chairman Cox noted that smaller companies in particular will see specific benefits.

Mr. Cox concluded his remarks by stating that, because smaller companies should benefit from the scalability of the SEC's final guidance, it does not appear that any additional postponement is necessary for Section 404 compliance by these companies. He acknowledged that there had been comments in the past that the Commission might delay further the filing requirements for smaller companies if the SEC didn't issue guidance in time. However, the SEC staff has concluded, and the Commissioners have agreed, that the final guidance released today is sufficient for this purpose. The Chairman added that compliance with Section 404 by smaller companies would only further the goal of Sarbanes-Oxley, implicitly alluding to the reports of an increasing trend of restated financial statements by non-accelerated filers.

Changes to the Proposed Interpretive Guidance

The SEC staff noted that wholesale changes to the proposed guidance were not warranted. However, the staff clarified and improved the guidance around two broad principles:

- (1) Management should evaluate whether it has implemented ICFR that adequately addresses whether a material error or misstatement would not be prevented or detected on a timely basis.
- (2) Management's evaluation of ICFR should be based on its assessment of risk.

Under the guidance, management can align the nature and extent of the evaluation to focus on those areas of highest risk to reliable financial reports. For example, management may be able to use self-assessment in low risk areas.

While some commenters asked the SEC to include in the guidance illustrative examples in areas such as IT general controls, the assessment of risk and the issue as to how risk affects the nature, timing and extent of the evaluation procedures, the SEC staff reported that they were cautious about doing so. They concluded that additional specificity would have negative consequences resulting in "bright line tests" and "one-size-fits-all" behavior, leading to more checklists. The SEC staff indicated that their intent was to avoid evaluations that were more concerned with form than with effectiveness.

However, the SEC staff did make a few modifications to the proposed guidance. These changes were summarized during the meeting using the four categories below:

- Align the SEC's guidance and the PCAOB's AS2 revisions: There were differences in terminology, definitions and approaches between the SEC's proposed guidance and the PCAOB's proposed revisions. Some commenters observed that the efficiencies would be limited by the more prescriptive auditor requirements articulated by the PCAOB. To address this issue, the SEC staff worked with the PCAOB staff to more closely align, among other things, the definition of a material weakness and the factors to consider when identifying financial reporting risks. However, some differences will remain between the final guidance and the new Auditing Standard No. 5 (AS5). According to the SEC staff, these differences are not necessarily contradictions. They reflect the different roles and responsibilities of management and the auditor. Management's daily involvement with the business provides it with knowledge and information about how to perform its evaluation of ICFR that an

auditor does not have available. Therefore, differences in approaches are likely to exist naturally because the auditor does not have the perspective of an insider.

- Clarify further how entity-level controls can impact management's evaluation: The SEC staff expanded the discussion around entity-level controls and how they relate to financial reporting elements. The staff clarified that some entity-level controls have an important, but indirect, effect on whether a misstatement could be detected. Therefore, some entity-level controls could be designed to detect a breakdown in other controls. In these cases, management would identify the controls that adequately address financial reporting risk, such as those controls functioning at the account and transaction level. Management should also consider both entity-level controls and transaction-level controls. The controls management identifies should include entity-level controls and other pervasive controls that support the effectiveness of ICFR. Management should also consider the control environment and those controls that are necessary to ensure reliable financial reporting.
- Address use of self-assessment and other ongoing monitoring activities: The staff expanded the guidance to clarify how activities related to self-assessment and other monitoring activities can vary as well as support management's evaluation process. These activities are important because they demonstrate how management's assessment can obtain information about the effectiveness of ICFR from management's daily activities in, and involvement with, critical business processes, rather than relying solely on independent third-party testing. The guidance recommends that management consider the objectivity of individuals performing these activities when evaluating the testing evidence. When evaluating objectivity of personnel, management is not required to reach an absolute conclusion. Management's assessment of objectivity can vary – based on job function, status in the company and relation to the process under review. Management should consider its evaluation of objectivity when assessing the sufficiency of the evidence supporting the effectiveness of ICFR.
- Increase the focus on the risk of fraudulent reporting: While the proposed guidance included general guidance on this topic, the SEC staff enhanced the final guidance by explaining that the risk of fraudulent reporting will exist in almost all companies. The existence of fraud risk does not mean that fraud has occurred. A rigorous evaluation would address fraudulent reporting risk, including the risk of management override in the financial reporting process. The SEC staff asserted that most companies should consider these matters. Therefore, companies of all sizes should have controls to prevent and detect management override.

An additional topic of discussion addressed Section 404 compliance by smaller companies and whether the final guidance is sufficient to address the concern that smaller companies bear a disproportionately high cost of compliance. The issue is particularly sensitive since several members of Congress have asked for a further extension for small companies. The staff said that management of small companies can comply now under the current filing requirement, asserting that they need to focus on two questions:

- (1) Do my employees understand what they need to do to prepare reliable financial statements?
- (2) What do I need to do to ensure my employees do what they are supposed to do?

The SEC staff commented that compliance with the interpretive guidance need not be costly, and it is achievable in a cost-effective manner by smaller companies using the SEC's final guidance.

Other Matters Discussed

The SEC staff also noted that they will be releasing updates to their Frequently Asked Questions guidance shortly. In this regard, several questions have been added specifically to address concerns related to foreign private issuers.

The SEC did not make changes in response to some commenters' requests to eliminate references to interim financial statements in the definition of a material weakness. The staff did not believe that this change would significantly reduce the amount of work required to evaluate and test ICFR. They said that the focus on interim materiality was limited solely to the evaluation of deficiencies and their effect on interim financial reports. The planning of a Section 404 evaluation is based solely on annual materiality.

The SEC also considered other matters on their agenda today. However, the matters discussed above are particularly relevant to their efforts over the past ten months to reform the Section 404 compliance process. Additional results of these collective efforts will be reported tomorrow with an open meeting of the PCAOB to vote on a final standard for an audit of ICFR, as well as related conforming amendments to the Board's auditing standards and an amendment to the independence rules. If adopted, the new standard (AS5) would supersede AS2. Several Commissioners commented during today's meeting that achieving efficiencies in the Section 404 compliance process is dependent on the PCAOB's final auditing standard and its successful adoption by external auditors. Protiviti will issue a Flash Report tomorrow covering the results of the PCAOB's open meeting.

Concluding Comments

This Flash Report has focused on the SEC's modifications to the proposed guidance discussed previously in prior Flash reports issued in December 2006. When the final SEC guidance is issued, it will be posted at www.sec.gov.