

SEC FLASH REPORT

SEC Publishes Final Interpretive Guidance, Issues Auditing Standard No. 5 for Public Comment and Proposes a New Definition of Significant Deficiency

June 21, 2007

Yesterday, the Securities and Exchange Commission (SEC) finally published its long-awaited interpretive guidance for management regarding a company's evaluation and assessment of internal control over financial reporting (ICFR). The final guidance is effective immediately once published in the Federal Register. The guidance is available at <http://www.sec.gov/rules/final.shtml>.

The SEC also adopted the following amendments:

- (1) Amended Exchange Act Rules 13a-15(c) and 15d-15(c) to make it clear that an evaluation that complies with the Commission's interpretive guidance would satisfy the annual management evaluation required by those rules.
- (2) Amended 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.
- (3) Amended Exchange Act Rule 12b-2 and Rule 1-02 of Regulation S-X to define the term, "material weakness."

The above rule amendments are available at <http://www.sec.gov/news/whatsnew/wn062007.shtml> and are generally effective 60 days after publication in the Federal Register.

The SEC also issued a proposed amendment to Exchange Act Rule 12b-2 and Rule 1-02 of Regulation S-X to define the term, "significant deficiency." The text of the proposal is available at <http://www.sec.gov/rules/proposed.shtml>. Comments on this proposal are due on or before 24 days after publication in the Federal Register.

In addition, earlier this week, the Commission issued for public comment the Public Company Accounting Oversight Board's Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements*. This release is available at <http://www.sec.gov/news/whatsnew/wn061807.shtml>. Comments on the release are due by July 12, 2007.

There are no significant surprises evident in any of these expected actions by the Commission. All of the above matters were discussed in Protiviti's SEC Flash Report dated May 23, 2007, which is available on www.protiviti.com. As the SEC staff noted in the May 23 open meeting, there were no "wholesale changes" in the Commission's final guidance.

The message is that the SEC is essentially done with its efforts to make compliance with the Section 404 more cost-effective and everything is now on the books insofar as the 2007 audit cycle is concerned. Management should insist that the company's Section 404 evaluation team understand the SEC guidance and prepare to apply a robust top-down, risk-based approach. That is the only way to maximize the cost-effectiveness of the Section 404 compliance process in the coming year.

Protiviti has identified eight key decisions for aligning the company's risk assessment with the external auditor's risk assessment. These decisions are summarized below:

- (1) Select the significant accounts and disclosures (financial reporting elements)
- (2) Identify the financial reporting assertions relevant to each priority financial reporting element
- (3) Select the key controls that address the relevant assertions, considering the effectiveness of their design
- (4) Decide the documentation standards at different levels of risk
- (5) Consider the relative ICFR risk levels when deciding the evidence needed to support operational effectiveness
- (6) Determine the multi-location scoping considerations
- (7) Understand and apply the standards driving the auditor's use of the work of others
- (8) Establish the assessment methodology for evaluating the severity of control deficiencies

A white paper discussing these decisions is available. To obtain a copy, contact your nearest Protiviti office and obtain further insight on how the SEC's interpretive guidance alters the way these decisions are made and why these decisions are so important to managing the compliance process.