

Comments on SOX Section 404 Proposals

Reference is made to the SEC's 11 July 2006 Concept Release concerning guidance for management on the assessment of internal controls for financial reporting.

The Concept Release anticipates providing additional guidance in the form of a rule addressing the three following topics:

- Risk and control identification
- Management's evaluation
- Documentation requirements

Innospec agrees with the stated or implied comments in the Concept Release that:

1. SOX has improved internal controls
2. SOX should apply to all listed companies
3. A listed company should comment on its internal controls over financial reporting
4. Management must decide its own assessment process to make such comment
5. The assessment process must be based on a recognised framework, e.g. COSO
6. And it should also be based on a top-down risk-based approach*
7. IT should be used wherever practical to give efficient, effective, economic controls

Innospec also believes that further guidance on S404 should:

- a) emphasise the COSO Control Environment attributes, e.g. attitude to ethics, quality of people, rather than detailed COSO Control Activities testing. This is especially relevant to smaller companies, e.g. segregation of duties issues.
- b) place more audit emphasis on the competency of the people involved in the processes, rather than on the mechanics of the processes and the transactions. This is an approach that has developed in the European ISO quality programs since the 1990s.
- c) re-emphasise the importance of the link between business risk management and S404. True business risk management is an involved concept that takes time to implement and maintain, especially in a fit-for-purpose form. Its adoption should help focus S404 work on key areas.
- d) aim to reduce the amount of detailed testing; appropriate relevant detailed testing would add more value and would support S404's objectives in the longer term; there's a growing perception that S404 testing in its present form adds little or no value; quote: "the reverse of the 80:20 Rule".
- e) place more reliance on a high quality internal audit function
- f) include more guidance on what entity-level controls are required.
- g) include specific guidance on the level of testing required on anti-fraud controls.
- h) re-define the various S404 definitions of the various types of deficiency. Past definitions have contributed to overkill in detailed testing and excessive external auditor expectations of management testing.