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Securities and Exchange Commission  
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## **Response to**

Concept release concerning management's reports on  
internal control over financial reporting

I would like to take the opportunity to respond to this concept release.

## **Background**

Based on the following from section "I. Background" there is a requirement "to contain an internal control report: (1) stating management's responsibilities for establishing and maintaining adequate internal control structure and procedures for financial reporting; and (2) containing an assessment, as of the end of the company's most recent fiscal year, of the effectiveness of the company's internal controls and procedures for financial reporting."<sup>1</sup>

It would appear reasonable that a company's internal control structure would continually develop in response to regulatory change and the requirement to maintain adequate internal controls over the course of a fiscal year.

However, whilst management is given "flexibility in adopting our rules implementing Section 404, our rules do require management to base its assessment of a company's internal control on a suitable evaluation framework"<sup>2</sup>. Thus it would appear management have access to a limited set of options in terms of frameworks with which to establish and maintain adequate internal controls whilst being responsible for the results delivered. In this environment "risk and control identification, management's evaluation, and documentation requirements"<sup>3</sup> have been identified as key areas requiring additional guidance to assist "management implement a "top-down, risk-based" approach".<sup>4</sup>

One limitation is placed on this guidance - "Any additional management guidance that we may issue is not intended to replace or modify the COSO framework or any other suitable framework."<sup>5</sup>

## **Suggestion – Compliance Layer**

Rather than pursuing further modifications to evaluation frameworks or operations, one alternative is to use an independent compliance layer. Whereas the time perspective of operations is always in the 'now' and moving forward, this compliance layer would be separate from operations and enable any point or period in time to be reproduced and examined.

For example, an independent compliance layer would allow stock options to be viewed from two perspectives:

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<sup>1</sup> SEC 34-54122.pdf Page 3.

<sup>2</sup> SEC 34-54122.pdf Page 7

<sup>3</sup> SEC 34-54122.pdf Page 5

<sup>4</sup> SEC 34-54122.pdf Page 17

<sup>5</sup> SEC 34-54122.pdf Page 8

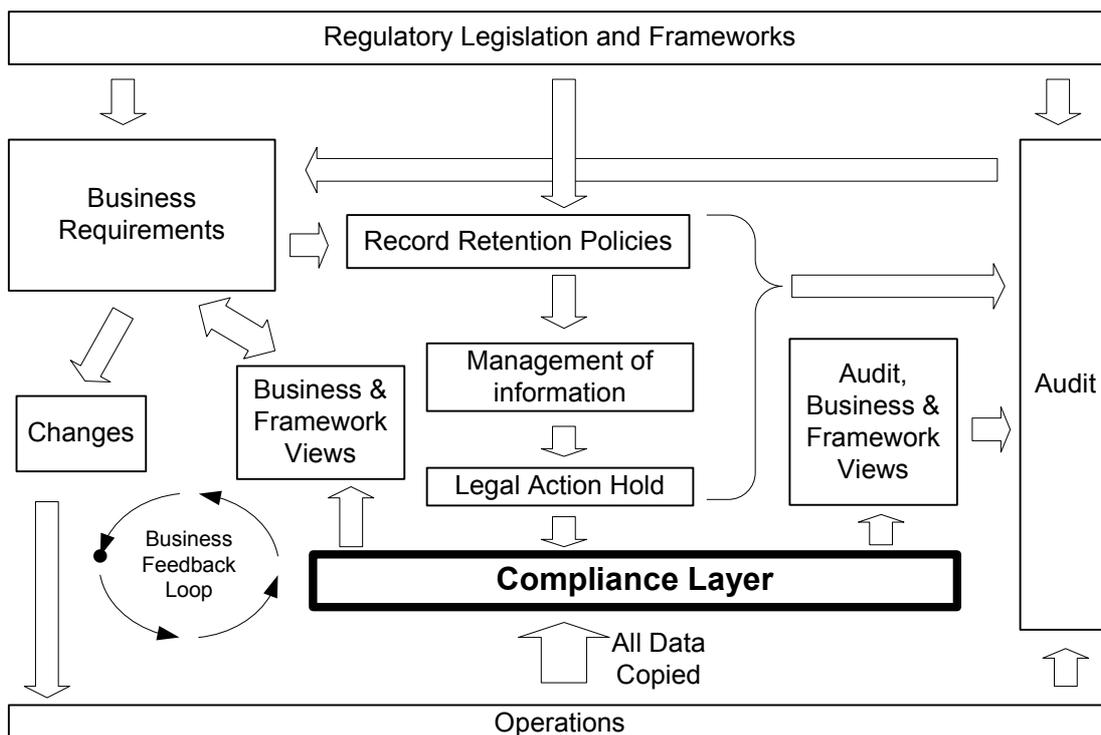
1. The environment as it was at the point in time they were said to be allocated. This will reproduce the events at this point in time to see if the allocation of stock options occurred.
2. The environment as it was at the point in time they were actually allocated. This will reproduce the events at this point in time to determine the actual date the allocation took place and some perspective as to how it was implemented.

This example shows how the compliance layer enables a dynamic top down approach to identify inconsistencies requiring further attention by management, auditors and/or regulators. Whilst these top down investigations may result in action being taken to correct deficiencies in operations, these corrections will be specifically applied, rather than a broad brush approach of attempting to predict and prevent any issue that may or may not arise.

In broad terms the independent compliance layer would:

- Enable access to top down views.
- Enable flow of information to the top.
- Operate independently of operations removing the historical requirements from operations.
- Enable the joining of diverse information sources that are incompatible at an operational level.
- Enable auditors to sample data movement from operations to compliance layer and then use views of the compliance layer to determine areas of 'concern'.
- Enable multiple framework views to exist in parallel, allowing areas of conflicting requirements to be explored without requiring operational change.
- Enable records management to be separated from operations and managed in an automated and consistent way across the organisation.
- Minimise the impact of change in operations on the regulatory framework and vice versa allowing the opportunity for greater flexibility.

An appropriately implemented independent compliance layer is, because of the different regulatory frameworks and operational combinations, likely to be different for each company. Conceptually, one approach to implementation could be:



As no two companies are identical, it is likely that no two implementations will be identical. However, the separation of compliance and operations will enable companies to overlay common audit and regulatory views as required. This provides the consistency of information expected without sacrificing any competitive edge at an operational level.

Adhering to compliance regulations is not the only benefit of implementing a separate compliance layer. Greater operational flexibility can be achieved as the separation prevents changes to either operations or compliance from 'rippling' through the company, reducing operational change costs and complexity. Human interfaces are able to be implemented in the compliance layer to view information from fully automated operational solutions that are effectively 'invisible' today. Joining operational information that has previously been too costly or complex may now be able to be joined within compliance. Records management, which is often costly, inconsistent and largely manual, is able to utilise the large amount of linked information within the compliance layer to centralise, automate and increase consistency of the records. Where complex corporate structures, or other situations, require access to information outside the company, the compliance layer provides a way to exchange the required information without the risks associated with the exposure of the operations layer.

## Conclusion

Adoption of this alternative implementation provides:

- For management to view their organisation top down at any point or period in time.
- The improved higher level visibility will provide more quantitative information to support management's judgement. In instances where management's judgement is later questioned, the compliance layer can reproduce the information used by and available to management as it was at that point in time.
- As more operational sources are incorporated into the compliance layer a more holistic view of the organisation is provided. This broader view should reduce instances of backdating or altering of records due to the complexity and resources required to successfully alter every source consistently.
- A single consistently operated records management approach based on the capture of all records and then, the scheduled destruction based on common rules, should reduce many of the documentation requirement issues.

Whilst it is not possible to provide a risk free environment it is not unreasonable to expect an environment where the gaming or cheating of the system is minimised, to provide a more appropriate investment standard.

Regards

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