

**SECURITIES AND EXCHANGE COMMISSION**

**17 CFR PART 241**

**[RELEASE NOS. 33-8810; 34-55929; FR-77; File No. S7-24-06]**

**Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934**

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Interpretation.

**SUMMARY:** The SEC is publishing this interpretive release to provide guidance for management regarding its evaluation and assessment of internal control over financial reporting. The guidance sets forth an approach by which management can conduct a top-down, risk-based evaluation of internal control over financial reporting. An evaluation that complies with this interpretive guidance is one way to satisfy the evaluation requirements of Rules 13a-15(c) and 15d-15(c) under the Securities Exchange Act of 1934.

**EFFECTIVE DATE:** June 27, 2007.

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**SUPPLEMENTARY INFORMATION:** The amendments to Rules 13a-15(c)<sup>1</sup> and 15d-15(c)<sup>2</sup> under the Securities Exchange Act of 1934<sup>3</sup> (the "Exchange Act"), which

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<sup>1</sup> 17 CFR 240.13a-15(c).

<sup>2</sup> 17 CFR 240.15d-15(c).

<sup>3</sup> 15 U.S.C. 78a *et seq.*

clarify that an evaluation of internal control over financial reporting that complies with this interpretive guidance is one way to satisfy those rules, are being made in a separate release.<sup>4</sup>

## **I. Introduction**

Management is responsible for maintaining a system of internal control over financial reporting (“ICFR”) that provides reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. The rules we adopted in June 2003 to implement Section 404 of the Sarbanes-Oxley Act of 2002<sup>5</sup> (“Sarbanes-Oxley”) require management to annually evaluate whether ICFR is effective at providing reasonable assurance and to disclose its assessment to investors.<sup>6</sup> Management is responsible for maintaining evidential matter, including documentation, to provide reasonable support for its assessment. This evidence will also allow a third party, such as the company’s external auditor, to consider the work performed by management.

ICFR cannot provide absolute assurance due to its inherent limitations; it is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. ICFR also can be circumvented by collusion or improper management override. Because of such limitations, ICFR cannot prevent or detect all misstatements, whether unintentional errors or fraud. However, these inherent limitations are known features of the financial

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<sup>4</sup> Release No. 34-55928 (Jun. 20, 2007).

<sup>5</sup> 15 U.S.C. 7262.

<sup>6</sup> Release No. 33-8238 (Jun. 5, 2003) [68 FR 36636] (hereinafter “Adopting Release”).

reporting process, therefore, it is possible to design into the process safeguards to reduce, though not eliminate, this risk.

The “reasonable assurance” referred to in the Commission’s implementing rules relates to similar language in the Foreign Corrupt Practices Act of 1977 (“FCPA”).<sup>7</sup> Exchange Act Section 13(b)(7) defines “reasonable assurance” and “reasonable detail” as “such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs.”<sup>8</sup> The Commission has long held that “reasonableness” is not an “absolute standard of exactitude for corporate records.”<sup>9</sup> In addition, the Commission recognizes that while “reasonableness” is an objective standard, there is a range of judgments that an issuer might make as to what is “reasonable” in implementing Section 404 and the Commission’s rules. Thus, the terms “reasonable,” “reasonably,” and “reasonableness” in the context of Section 404 implementation do not imply a single conclusion or methodology, but encompass the full range of appropriate potential conduct, conclusions or methodologies upon which an issuer may reasonably base its decisions.

Since companies first began complying in 2004, the Commission has received significant feedback on our rules implementing Section 404.<sup>10</sup> This feedback included requests for further guidance to assist company management in complying with our ICFR

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<sup>7</sup> Title 1 of Pub. L. 95-213 (1977).

<sup>8</sup> 15 U.S.C. 78m(b)(7). The conference committee report on the 1988 amendments to the FCPA also noted that the standard “does not connote an unrealistic degree of exactitude or precision. The concept of reasonableness of necessity contemplates the weighing of a number of relevant factors, including the costs of compliance.” Cong. Rec. H2116 (daily ed. Apr. 20, 1988).

<sup>9</sup> Release No. 34-17500 (Jan. 29, 1981) [46 FR 11544].

<sup>10</sup> Release Nos. 33-8762; 34-54976 (Dec. 20, 2006) [71 FR 77635] (hereinafter “Proposing Release”). For a detailed history of the implementation of Section 404 of Sarbanes-Oxley, see Section I., Background, of the Proposing Release. An analysis of the comments we received on the Proposing Release is included in Section III of this release.

evaluation and disclosure requirements. This guidance is in response to those requests and reflects the significant feedback we have received, including comments on the interpretive guidance we proposed on December 20, 2006. In addressing a number of the commonly identified areas of concerns, the interpretive guidance:

- Explains how to vary evaluation approaches for gathering evidence based on risk assessments;
- Explains the use of “daily interaction,” self-assessment, and other on-going monitoring activities as evidence in the evaluation;
- Explains the purpose of documentation and how management has flexibility in approaches to documenting support for its assessment;
- Provides management significant flexibility in making judgments regarding what constitutes adequate evidence in low-risk areas; and
- Allows for management and the auditor to have different testing approaches.

The Interpretive Guidance is organized around two broad principles. The first principle is that management should evaluate whether it has implemented controls that adequately address the risk that a material misstatement of the financial statements would not be prevented or detected in a timely manner. The guidance describes a top-down, risk-based approach to this principle, including the role of entity-level controls in assessing financial reporting risks and the adequacy of controls. The guidance promotes efficiency by allowing management to focus on those controls that are needed to adequately address the risk of a material misstatement of its financial statements. The guidance does not require management to identify every control in a process or document the business processes impacting ICFR. Rather, management can focus its evaluation

process and the documentation supporting the assessment on those controls that it determines adequately address the risk of a material misstatement of the financial statements. For example, if management determines that a risk of a material misstatement is adequately addressed by an entity-level control, no further evaluation of other controls is required.

The second principle is that management's evaluation of evidence about the operation of its controls should be based on its assessment of risk. The guidance provides an approach for making risk-based judgments about the evidence needed for the evaluation. This allows management to align the nature and extent of its evaluation procedures with those areas of financial reporting that pose the highest risks to reliable financial reporting (that is, whether the financial statements are materially accurate). As a result, management may be able to use more efficient approaches to gathering evidence, such as self-assessments, in low-risk areas and perform more extensive testing in high-risk areas. By following these two principles, we believe companies of all sizes and complexities will be able to implement our rules effectively and efficiently.

The Interpretive Guidance reiterates the Commission's position that management should bring its own experience and informed judgment to bear in order to design an evaluation process that meets the needs of its company and that provides a reasonable basis for its annual assessment of whether ICFR is effective. This allows management sufficient and appropriate flexibility to design such an evaluation process.<sup>11</sup>

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<sup>11</sup> Exchange Act Rules 13a-15 and 15d-15 [17 CFR 240.13a-15 and 15d-15] require management to evaluate the effectiveness of ICFR as of the end of the fiscal year. For purposes of this document, the term "evaluation" or "evaluation process" refers to the methods and procedures that management implements to comply with these rules. The term "assessment" is used in this document to describe the disclosure required by Item 308 of Regulations S-B and S-K [17 CFR 228.308 and 229.308]. This disclosure must include discussion of any material weaknesses

Smaller public companies, which generally have less complex internal control systems than larger public companies, can use this guidance to scale and tailor their evaluation methods and procedures to fit their own facts and circumstances. We encourage smaller public companies<sup>12</sup> to take advantage of the flexibility and scalability to conduct an evaluation of ICFR that is both efficient and effective at identifying material weaknesses.

The effort necessary to conduct an initial evaluation of ICFR will vary among companies, partly because this effort will depend on management's existing financial reporting risk assessment and control monitoring activities. After the first year of compliance, management's effort to identify financial reporting risks and controls should ordinarily be less, because subsequent evaluations should be more focused on changes in risks and controls rather than identification of all financial reporting risks and the related controls. Further, in each subsequent year, the documentation of risks and controls will only need to be updated from the prior year(s), not recreated anew. Through the risk and control identification process, management will have identified for testing only those controls that are needed to meet the objective of ICFR (that is, to provide reasonable assurance regarding the reliability of financial reporting) and for which evidence about their operation can be obtained most efficiently. The nature and extent of procedures

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which exist as of the end of the most recent fiscal year and management's assessment of the effectiveness of ICFR, including a statement as to whether or not ICFR is effective. Management is not permitted to conclude that ICFR is effective if there are one or more material weaknesses in ICFR.

<sup>12</sup> While a company's individual facts and circumstances should be considered in determining whether a company is a smaller public company and the resulting implications to management's evaluation, a company's public market capitalization and annual revenues are useful indicators of its size and complexity. The Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission (Apr. 23, 2006), available at <http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf>, defined smaller companies, which included microcap companies, and the SEC's rules include size characteristics for "accelerated filers" and "non-accelerated filers" which approximately fit the same definitions.

implemented to evaluate whether those controls continue to operate effectively can be tailored to the company's unique circumstances, thereby avoiding unnecessary compliance costs.

The guidance assumes management has established and maintains a system of internal accounting controls as required by the FCPA. Further, it is not intended to explain how management should design its ICFR to comply with the control framework management has chosen. To allow appropriate flexibility, the guidance does not provide a checklist of steps management should perform in completing its evaluation.

The guidance in this release shall be effective immediately upon its publication in the Federal Register.<sup>13</sup>

As a companion<sup>14</sup> to this interpretive release, we are adopting amendments to Exchange Act Rules 13a-15(c) and 15d-15(c) and revisions to Regulation S-X.<sup>15</sup> The amendments to Rules 13a-15(c) and 15d-15(c) will make it clear that an evaluation that is conducted in accordance with this interpretive guidance is one way to satisfy the annual management evaluation requirement in those rules. We are also amending our rules to define the term "material weakness" and to revise the requirements regarding the auditor's attestation report on ICFR. Additionally, we are seeking additional comment on the definition of the term "significant deficiency."<sup>16</sup>

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<sup>13</sup> The Commission finds good cause under 5 U.S.C. 808(2) for this interpretation to take effect on the date of Federal Register publication. Further delay would be unnecessary and contrary to the public interest because following the guidance is voluntary. Additionally, delay may deter companies from realizing all the efficiencies intended by this guidance, and immediate effectiveness will assist in preparing for 2007 evaluations and assessments of internal control over financial reporting.

<sup>14</sup> Release No. 34-55928.

<sup>15</sup> 17 CFR 210.1-01 et seq.

<sup>16</sup> Release No. 34-55930 (Jun. 20, 2007).

## **II. Interpretive Guidance – Evaluation and Assessment of Internal Control Over Financial Reporting**

The interpretive guidance addresses the following topics:

### **A. The Evaluation Process**

#### **1. Identifying Financial Reporting Risks and Controls**

- a. Identifying Financial Reporting Risks
- b. Identifying Controls that Adequately Address Financial Reporting Risks
- c. Consideration of Entity-Level Controls
- d. Role of Information Technology General Controls
- e. Evidential Matter to Support the Assessment

#### **2. Evaluating Evidence of the Operating Effectiveness of ICFR**

- a. Determining the Evidence Needed to Support the Assessment
- b. Implementing Procedures to Evaluate Evidence of the Operation of ICFR
- c. Evidential Matter to Support the Assessment

#### **3. Multiple Location Considerations**

### **B. Reporting Considerations**

1. Evaluation of Control Deficiencies
2. Expression of Assessment of Effectiveness of ICFR by Management
3. Disclosures about Material Weaknesses
4. Impact of a Restatement of Previously Issued Financial Statements on Management's Report on ICFR
5. Inability to Assess Certain Aspects of ICFR



## A. The Evaluation Process

The objective of internal control over financial reporting<sup>17</sup> (“ICFR”) is to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles (“GAAP”). The purpose of the evaluation of ICFR is to provide management with a reasonable basis for its annual assessment as to whether any material weaknesses<sup>18</sup> in ICFR exist as of the end of the fiscal year.<sup>19</sup> To accomplish this, management identifies the risks to reliable financial reporting, evaluates whether controls exist to address those risks, and evaluates evidence about the operation of the controls

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<sup>17</sup> Exchange Act Rules 13a-15(f) and 15d-15(f) [17 CFR 240.13a-15(f) and 15d-15(b)] define internal control over financial reporting as:

A process designed by, or under the supervision of, the issuer’s principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer’s board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- (1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
- (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the registrant; and
- (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer’s assets that could have a material effect on the financial statements.

<sup>18</sup> As defined in Exchange Act Rule 12b-2 [17 CFR 240.12b-2] and Rule 1-02 of Regulation S-X [17 CFR 210.1-02], a material weakness is a deficiency, or a combination of deficiencies, in ICFR such that there is a reasonable possibility that a material misstatement of the registrant’s annual or interim financial statements will not be prevented or detected on a timely basis. See Release No. 34-55928.

<sup>19</sup> This focus on material weaknesses will lead to a better understanding by investors about the company’s ICFR, as well as its inherent limitations. Further, the Commission’s rules implementing Section 404, by providing for public disclosure of material weaknesses, concentrate attention on the most important internal control issues.

included in the evaluation based on its assessment of risk.<sup>20</sup> The evaluation process will vary from company to company; however, the top-down, risk-based approach which is described in this guidance will typically be the most efficient and effective way to conduct the evaluation.

The evaluation process guidance is described in two sections. The first section explains the identification of financial reporting risks and the evaluation of whether the controls management has implemented adequately address those risks. The second section explains an approach for making judgments about the methods and procedures for evaluating whether the operation of ICFR is effective. Both sections explain how entity-level controls<sup>21</sup> impact the evaluation process, as well as how management should focus its evaluation efforts on the highest risks to reliable financial reporting.<sup>22</sup>

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<sup>20</sup> If management's evaluation process identifies material weaknesses, but all material weaknesses are remediated by the end of the fiscal year, management may conclude that ICFR is effective as of the end of the fiscal year. However, management should consider whether disclosure of such remediated material weaknesses is appropriate or required under Item 307 or Item 308 of Regulations S-K or S-B or other Commission disclosure rules.

<sup>21</sup> The term "entity-level controls" as used in this document describes aspects of a system of internal control that have a pervasive effect on the entity's system of internal control such as controls related to the control environment (for example, management's philosophy and operating style, integrity and ethical values; board or audit committee oversight; and assignment of authority and responsibility); controls over management override; the company's risk assessment process; centralized processing and controls, including shared service environments; controls to monitor results of operations; controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs; controls over the period-end financial reporting process; and policies that address significant business control and risk management practices. The terms "company-level" and "entity-wide" are also commonly used to describe these controls.

<sup>22</sup> Because management is responsible for maintaining effective ICFR, this interpretive guidance does not specifically address the role of the board of directors or audit committee in a company's evaluation and assessment of ICFR. However, we would ordinarily expect a board of directors or audit committee, as part of its oversight responsibilities for the company's financial reporting, to be reasonably knowledgeable and informed about the evaluation process and management's assessment, as necessary in the circumstances.

Under the Commission’s rules, management’s annual assessment of the effectiveness of ICFR must be made in accordance with a suitable control framework’s<sup>23</sup> definition of effective internal control.<sup>24</sup> These control frameworks define elements of internal control that are expected to be present and functioning in an effective internal control system. In assessing effectiveness, management evaluates whether its ICFR includes policies, procedures and activities that address the elements of internal control that the applicable control framework describes as necessary for an internal control system to be effective. The framework elements describe the characteristics of an internal control system that may be relevant to individual areas of the company’s ICFR, pervasive to many areas, or entity-wide. Therefore, management’s evaluation process includes not only controls involving particular areas of financial reporting, but also the entity-wide and other pervasive elements of internal control defined by its selected control framework. This guidance is not intended to replace the elements of an effective system of internal control as defined within a control framework.

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<sup>23</sup> In the Adopting Release, the Commission specified characteristics of a suitable control framework and identified the Internal Control—Integrated Framework (1992) created by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) as an example of a suitable framework. We also cited the Guidance on Assessing Control published by the Canadian Institute of Chartered Accountants (“CoCo”) and the report published by the Institute of Chartered Accountants in England & Wales Internal Control: Guidance for Directors on the Combined Code (known as the Turnbull Report) as examples of other suitable frameworks that issuers could choose in evaluating the effectiveness of their ICFR. We encourage companies to examine and select a framework that may be useful in their own circumstances; we also encourage the further development of existing and alternative frameworks.

<sup>24</sup> For example, both the COSO framework and the Turnbull Report state that determining whether a system of internal control is effective is a subjective judgment resulting from an assessment of whether the five components (that is, control environment, risk assessment, control activities, monitoring, and information and communication) are present and functioning effectively. Although CoCo states that an assessment of effectiveness should be made against twenty specific criteria, it acknowledges that the criteria can be regrouped into different structures, and includes a table showing how the criteria can be regrouped into the five-component structure of COSO.

## **1. Identifying Financial Reporting Risks and Controls**

Management should evaluate whether it has implemented controls that will achieve the objective of ICFR (that is, to provide reasonable assurance regarding the reliability of financial reporting). The evaluation begins with the identification and assessment of the risks to reliable financial reporting (that is, materially accurate financial statements), including changes in those risks. Management then evaluates whether it has controls placed in operation (that is, in use) that are designed to adequately address those risks. Management ordinarily would consider the company's entity-level controls in both its assessment of risks and in identifying which controls adequately address the risks.

The evaluation approach described herein allows management to identify controls and maintain supporting evidential matter for its controls in a manner that is tailored to the company's financial reporting risks (as defined below). Thus, the controls that management identifies and documents are those that are important to achieving the objective of ICFR. These controls are then subject to procedures to evaluate evidence of their operating effectiveness, as determined pursuant to Section II.A.2.

### **a. Identifying Financial Reporting Risks**

Management should identify those risks of misstatement that could, individually or in combination with others, result in a material misstatement of the financial statements ("financial reporting risks"). Ordinarily, the identification of financial reporting risks begins with evaluating how the requirements of GAAP apply to the company's business, operations and transactions. Management must provide investors with financial statements that fairly present the company's financial position, results of operations and cash flows in accordance with GAAP. A lack of fair presentation arises

when one or more financial statement amounts or disclosures (“financial reporting elements”) contain misstatements (including omissions) that are material.

Management uses its knowledge and understanding of the business, and its organization, operations, and processes, to consider the sources and potential likelihood of misstatements in financial reporting elements. Internal and external risk factors that impact the business, including the nature and extent of any changes in those risks, may give rise to a risk of misstatement. Risks of misstatement may also arise from sources such as the initiation, authorization, processing and recording of transactions and other adjustments that are reflected in financial reporting elements. Management may find it useful to consider “what could go wrong” within a financial reporting element in order to identify the sources and the potential likelihood of misstatements and identify those that could result in a material misstatement of the financial statements.

The methods and procedures for identifying financial reporting risks will vary based on the characteristics of the company. These characteristics include, among others, the size, complexity, and organizational structure of the company and its processes and financial reporting environment, as well as the control framework used by management. For example, to identify financial reporting risks in a larger business or a complex business process, management’s methods and procedures may involve a variety of company personnel, including those with specialized knowledge. These individuals, collectively, may be necessary to have a sufficient understanding of GAAP, the underlying business transactions and the process activities, including the role of computer technology, that are required to initiate, authorize, record and process transactions. In contrast, in a small company that operates on a centralized basis with less complex

business processes and with little change in the risks or processes, management's daily involvement with the business may provide it with adequate knowledge to appropriately identify financial reporting risks.

Management's evaluation of the risk of misstatement should include consideration of the vulnerability of the entity to fraudulent activity (for example, fraudulent financial reporting, misappropriation of assets and corruption), and whether any such exposure could result in a material misstatement of the financial statements.<sup>25</sup> The extent of activities required for the evaluation of fraud risks is commensurate with the size and complexity of the company's operations and financial reporting environment.<sup>26</sup>

Management should recognize that the risk of material misstatement due to fraud ordinarily exists in any organization, regardless of size or type, and it may vary by specific location or segment and by individual financial reporting element. For example, one type of fraud risk that has resulted in fraudulent financial reporting in companies of all sizes and types is the risk of improper override of internal controls in the financial reporting process. While the identification of a fraud risk is not necessarily an indication that a fraud has occurred, the absence of an identified fraud is not an indication that no

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<sup>25</sup> For example, COSO's Internal Control Over Financial Reporting – Guidance for Smaller Public Companies (2006), Volume 1: Executive Summary, Principle 10: Fraud Risk (page 10) states, "The potential for material misstatement due to fraud is explicitly considered in assessing risks to the achievement of financial reporting objectives."

<sup>26</sup> Management may find resources such as "Management Antifraud Programs and Controls – Guidance to Help Prevent, Deter, and Detect Fraud," which was issued jointly by seven professional organizations and is included as an exhibit to AU Sec. 316, Consideration of Fraud in a Financial Statement Audit (as adopted on an interim basis by the PCAOB in PCAOB Rule 3200T) helpful in assessing fraud risks. Other resources also exist (for example, the American Institute of Certified Public Accountants' (AICPA) Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention (2005)), and more may be developed in the future.

fraud risks exist. Rather, these risk assessments are used in evaluating whether adequate controls have been implemented.

#### **b. Identifying Controls that Adequately Address Financial Reporting Risks**

Management should evaluate whether it has controls<sup>27</sup> placed in operation (that is, in use) that adequately address the company's financial reporting risks. The determination of whether an individual control, or a combination of controls, adequately addresses a financial reporting risk involves judgments about whether the controls, if operating properly, can effectively prevent or detect misstatements that could result in material misstatements in the financial statements.<sup>28</sup> If management determines that a deficiency in ICFR exists, it must be evaluated to determine whether a material weakness exists.<sup>29</sup> The guidance in Section II.B.1. is designed to assist management with that evaluation.

Management may identify preventive controls, detective controls, or a combination of both, as adequately addressing financial reporting risks.<sup>30</sup> There might

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<sup>27</sup> A control consists of a specific set of policies, procedures, and activities designed to meet an objective. A control may exist within a designated function or activity in a process. A control's impact on ICFR may be entity-wide or specific to an account balance, class of transactions or application. Controls have unique characteristics – for example, they can be: automated or manual; reconciliations; segregation of duties; review and approval authorizations; safeguarding and accountability of assets; preventing or detecting error or fraud. Controls within a process may consist of financial reporting controls and operational controls (that is, those designed to achieve operational objectives).

<sup>28</sup> Companies may use “control objectives,” which provide specific criteria against which to evaluate the effectiveness of controls, to assist in evaluating whether controls can prevent or detect misstatements.

<sup>29</sup> A deficiency in the design of ICFR exists when (a) necessary controls are missing or (b) existing controls are not properly designed so that, even if the control operates as designed, the financial reporting risks would not be addressed.

<sup>30</sup> Preventive controls have the objective of preventing the occurrence of errors or fraud that could result in a misstatement of the financial statements. Detective controls have the objective of detecting errors or fraud that has already occurred that could result in a misstatement of the

be more than one control that addresses the financial reporting risks for a financial reporting element; conversely, one control might address the risks of more than one financial reporting element. It is not necessary to identify all controls that may exist or identify redundant controls, unless redundancy itself is required to address the financial reporting risks. To illustrate, management may determine that the risk of a misstatement in interest expense, which could result in a material misstatement of the financial statements, is adequately addressed by a control within the company's period-end financial reporting process (that is, an entity-level control). In such a case, management may not need to identify, for purposes of the ICFR evaluation, any additional controls related to the risk of misstatement in interest expense.

Management may also consider the efficiency with which evidence of the operation of a control can be evaluated when identifying the controls that adequately address the financial reporting risks. When more than one control exists and each adequately addresses a financial reporting risk, management may decide to select the control for which evidence of operating effectiveness can be obtained more efficiently. Moreover, when adequate information technology ("IT") general controls exist and management has determined that the operation of such controls is effective, management may determine that automated controls are more efficient to evaluate than manual controls. Considering the efficiency with which the operation of a control can be evaluated will often enhance the overall efficiency of the evaluation process.

In addition to identifying controls that address the financial reporting risks of individual financial reporting elements, management also evaluates whether it has

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financial statements. Preventive and detective controls may be completely manual, involve some degree of computer automation, or be completely automated.



controls in place to address the entity-level and other pervasive elements of ICFR that its chosen control framework prescribes as necessary for an effective system of internal control. This would ordinarily include, for example, considering how and whether controls related to the control environment, controls over management override, the entity-level risk assessment process and monitoring activities,<sup>31</sup> controls over the period-end financial reporting process,<sup>32</sup> and the policies that address significant business control and risk management practices are adequate for purposes of an effective system of internal control. The control frameworks and related guidance may be useful tools for evaluating the adequacy of these elements of ICFR.

When identifying the controls that address financial reporting risks, management learns information about the characteristics of the controls that should inform its judgments about the risk that a control will fail to operate as designed. This includes, for example, information about the judgment required in its operation and information about the complexity of the controls. Section II.A.2. discusses how these characteristics are considered in determining the nature and extent of evidence of the operation of the controls that management evaluates.

At the end of this identification process, management has identified for evaluation those controls that are needed to meet the objective of ICFR (that is, to provide

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<sup>31</sup> Monitoring activities may include controls to monitor results of operations and controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs.

<sup>32</sup> The nature of controls within the period-end financial reporting process will vary based on a company's facts and circumstances. The period-end financial reporting process may include matters such as: procedures to enter transaction totals into the general ledger; the initiation, authorization, recording and processing of journal entries in the general ledger; procedures for the selection and application of accounting policies; procedures used to record recurring and non-recurring adjustments to the annual and quarterly financial statements; and procedures for preparing annual and quarterly financial statements and related disclosures.

reasonable assurance regarding the reliability of financial reporting) and for which evidence about their operation can be obtained most efficiently.

### **c. Consideration of Entity-Level Controls**

Management considers entity-level controls when identifying financial reporting risks and related controls for a financial reporting element. In doing so, it is important for management to consider the nature of the entity-level controls and how those controls relate to the financial reporting element. The more indirect the relationship to a financial reporting element, the less effective a control may be in preventing or detecting a misstatement.<sup>33</sup>

Some entity-level controls, such as certain control environment controls, have an important, but indirect, effect on the likelihood that a misstatement will be prevented or detected on a timely basis. These controls might affect the other controls management determines are necessary to adequately address financial reporting risks for a financial reporting element. However, it is unlikely that management will identify only this type of entity-level control as adequately addressing a financial reporting risk identified for a financial reporting element.

Other entity-level controls may be designed to identify possible breakdowns in lower-level controls, but not in a manner that would, by themselves, adequately address financial reporting risks. For example, an entity-level control that monitors the results of operations may be designed to detect potential misstatements and investigate whether a breakdown in lower-level controls occurred. However, if the amount of potential

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<sup>33</sup> Controls can be either directly or indirectly related to a financial reporting element. Controls that are designed to have a specific effect on a financial reporting element are considered directly related. For example, controls established to ensure that personnel are properly counting and recording the annual physical inventory relate directly to the existence of the inventory.

misstatement that could exist before being detected by the monitoring control is too high, then the control may not adequately address the financial reporting risks of a financial reporting element.

Entity-level controls may be designed to operate at the process, application, transaction or account-level and at a level of precision that would adequately prevent or detect on a timely basis misstatements in one or more financial reporting elements that could result in a material misstatement of the financial statements. In these cases, management may not need to identify or evaluate additional controls relating to that financial reporting risk.

#### **d. Role of Information Technology General Controls**

Controls that management identifies as addressing financial reporting risks may be automated,<sup>34</sup> dependent upon IT functionality,<sup>35</sup> or a combination of both manual and automated procedures.<sup>36</sup> In these situations, management's evaluation process generally considers the design and operation of the automated or IT dependent application controls and the relevant IT general controls over the applications providing the IT functionality. While IT general controls alone ordinarily do not adequately address financial reporting risks, the proper and consistent operation of automated controls or IT functionality often depends upon effective IT general controls. The identification of risks and controls within IT should not be a separate evaluation. Instead, it should be an integral part of

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<sup>34</sup> For example, application controls that perform automated matching, error checking or edit checking functions.

<sup>35</sup> For example, consistent application of a formula or performance of a calculation and posting correct balances to appropriate accounts or ledgers.

<sup>36</sup> For example, a control that manually investigates items contained in a computer generated exception report.

management's top-down, risk-based approach to identifying risks and controls and in determining evidential matter necessary to support the assessment.

Aspects of IT general controls that may be relevant to the evaluation of ICFR will vary depending upon a company's facts and circumstances. For purposes of the evaluation of ICFR, management only needs to evaluate those IT general controls that are necessary for the proper and consistent operation of other controls designed to adequately address financial reporting risks. For example, management might consider whether certain aspects of IT general control areas, such as program development, program changes, computer operations, and access to programs and data, apply to its facts and circumstances.<sup>37</sup> Specifically, it is unnecessary to evaluate IT general controls that primarily pertain to efficiency or effectiveness of a company's operations, but which are not relevant to addressing financial reporting risks.

#### **e. Evidential Matter to Support the Assessment**

As part of its evaluation of ICFR, management must maintain reasonable support for its assessment.<sup>38</sup> Documentation of the design of the controls management has placed in operation to adequately address the financial reporting risks, including the entity-level and other pervasive elements necessary for effective ICFR, is an integral part of the reasonable support. The form and extent of the documentation will vary depending on the size, nature, and complexity of the company. It can take many forms (for example, paper documents, electronic, or other media). Also, the documentation

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<sup>37</sup> However, the reference to these specific IT general control areas as examples within this guidance does not imply that these areas, either partially or in their entirety, are applicable to all facts and circumstances. As indicated, companies need to take their particular facts and circumstances into consideration in determining which aspects of IT general controls are relevant.

<sup>38</sup> See instructions to Item 308 of Regulations S-K and S-B.

can be presented in a number of ways (for example, policy manuals, process models, flowcharts, job descriptions, documents, internal memorandums, forms, etc). The documentation does not need to include all controls that exist within a process that impacts financial reporting. Rather, the documentation should be focused on those controls that management concludes are adequate to address the financial reporting risks.<sup>39</sup>

In addition to providing support for the assessment of ICFR, documentation of the design of controls also supports other objectives of an effective system of internal control. For example, it serves as evidence that controls within ICFR, including changes to those controls, have been identified, are capable of being communicated to those responsible for their performance, and are capable of being monitored by the company.

## **2. Evaluating Evidence of the Operating Effectiveness of ICFR**

Management should evaluate evidence of the operating effectiveness of ICFR. The evaluation of the operating effectiveness of a control considers whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively. The evaluation procedures that management uses to gather evidence about the operation of the controls it identifies as adequately addressing the financial reporting risks for financial reporting elements (pursuant to Section II.A.1.b) should be tailored to management's assessment of the risk characteristics of both the individual financial reporting elements and the related controls (collectively, ICFR risk). Management should ordinarily focus its evaluation of the operation of controls on areas posing the highest ICFR risk. Management's

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<sup>39</sup> Section II.A.2.c also provides guidance with regard to the documentation required to support management's evaluation of operating effectiveness.

assessment of ICFR risk also considers the impact of entity-level controls, such as the relative strengths and weaknesses of the control environment, which may influence management's judgments about the risks of failure for particular controls.

Evidence about the effective operation of controls may be obtained from direct testing of controls and on-going monitoring activities. The nature, timing and extent of evaluation procedures necessary for management to obtain sufficient evidence of the effective operation of a control depend on the assessed ICFR risk. In determining whether the evidence obtained is sufficient to provide a reasonable basis for its evaluation of the operation of ICFR, management should consider not only the quantity of evidence (for example, sample size), but also the qualitative characteristics of the evidence. The qualitative characteristics of the evidence include the nature of the evaluation procedures performed, the period of time to which the evidence relates, the objectivity<sup>40</sup> of those evaluating the controls, and, in the case of on-going monitoring activities, the extent of validation through direct testing of underlying controls. For any individual control, different combinations of the nature, timing, and extent of evaluation procedures may provide sufficient evidence. The sufficiency of evidence is not necessarily determined by any of these attributes individually.

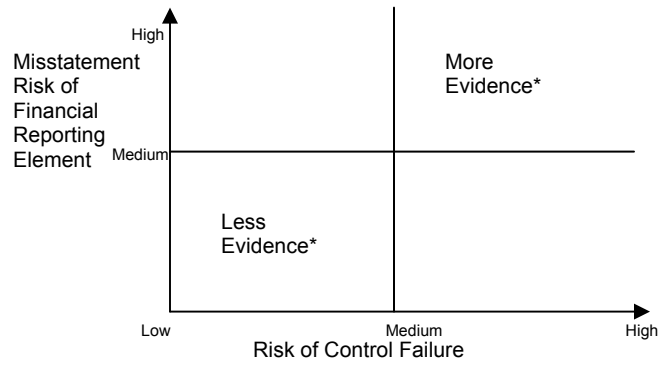
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<sup>40</sup> In determining the objectivity of those evaluating controls, management is not required to make an absolute conclusion regarding objectivity, but rather should recognize that personnel will have varying degrees of objectivity based on, among other things, their job function, their relationship to the control being evaluated, and their level of authority and responsibility within the organization. Personnel whose core function involves permanently serving as a testing or compliance authority at the company, such as internal auditors, normally are expected to be the most objective. However, the degree of objectivity of other company personnel may be such that the evaluation of controls performed by them would provide sufficient evidence. Management's judgments about whether the degree of objectivity is adequate to provide sufficient evidence should take into account the ICFR risk.

**a. Determining the Evidence Needed to Support the Assessment**

Management should evaluate the ICFR risk of the controls identified Section II.A.1.b as adequately addressing the financial reporting risks for financial reporting elements to determine the evidence needed to support the assessment. This evaluation should consider the characteristics of the financial reporting elements to which the controls relate and the characteristics of the controls themselves. This concept is illustrated in the following diagram.

Determining the Sufficiency of Evidence Based on ICFR Risk



\* The references to “more” or “less” include both the quantitative and qualitative characteristics of the evidence (that is, its sufficiency).



Management's consideration of the misstatement risk of a financial reporting element includes both the materiality of the financial reporting element and the susceptibility of the underlying account balances, transactions or other supporting information to a misstatement that could be material to the financial statements. As the materiality of a financial reporting element increases in relation to the amount of misstatement that would be considered material to the financial statements, management's assessment of misstatement risk for the financial reporting element generally would correspondingly increase. In addition, management considers the extent to which the financial reporting elements include transactions, account balances or other supporting information that are prone to material misstatement. For example, the extent to which a financial reporting element: (1) involves judgment in determining the recorded amounts; (2) is susceptible to fraud; (3) has complex accounting requirements; (4) experiences change in the nature or volume of the underlying transactions; or (5) is sensitive to changes in environmental factors, such as technological and/or economic developments, would generally affect management's judgment of whether a misstatement risk is higher or lower.

Management's consideration of the likelihood that a control might fail to operate effectively includes, among other things:

- The type of control (that is, manual or automated) and the frequency with which it operates;
- The complexity of the control;
- The risk of management override;
- The judgment required to operate the control;

- The competence of the personnel who perform the control or monitor its performance;
- Whether there have been changes in key personnel who either perform the control or monitor its performance;
- The nature and materiality of misstatements that the control is intended to prevent or detect;
- The degree to which the control relies on the effectiveness of other controls (for example, IT general controls); and
- The evidence of the operation of the control from prior year(s).

For example, management’s judgment of the risk of control failure would be higher for controls whose operation requires significant judgment than for non-complex controls requiring less judgment.

Financial reporting elements that involve related party transactions, critical accounting policies,<sup>41</sup> and related critical accounting estimates<sup>42</sup> generally would be assessed as having a higher misstatement risk. Further, when the controls related to these financial reporting elements are subject to the risk of management override, involve

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<sup>41</sup> “Critical accounting policies” are defined as those policies that are most important to the financial statement presentation, and require management’s most difficult, subjective, or complex judgments, often as the result of a need to make estimates about the effect of matters that are inherently uncertain. See Release No. 33-8040 (Dec. 12, 2001) [66 FR 65013].

<sup>42</sup> “Critical accounting estimates” relate to estimates or assumptions involved in the application of generally accepted accounting principles where the nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change and the impact of the estimates and assumptions on financial condition or operating performance is material. See Release No. 33-8350 (Dec. 19, 2003) [68 FR 75056]. For additional information, see, for example, Release No. 33-8098 (May 10, 2002) [67 FR 35620].

significant judgment, or are complex, they should generally be assessed as having higher ICFR risk.

When a combination of controls is required to adequately address the risks related to a financial reporting element, management should analyze the risk characteristics of the controls. This is because the controls associated with a given financial reporting element may not necessarily share the same risk characteristics. For example, a financial reporting element involving significant estimation may require a combination of automated controls that accumulate source data and manual controls that require highly judgmental determinations of assumptions. In this case, the automated controls may be subject to a system that is stable (that is, has not undergone significant change) and is supported by effective IT general controls and are therefore assessed as lower risk, whereas the manual controls would be assessed as higher risk.

The consideration of entity-level controls (for example, controls within the control environment) may influence management's determination of the evidence needed to sufficiently support its assessment of ICFR. For example, management's judgment about the likelihood that a control fails to operate effectively may be influenced by a highly effective control environment and thereby impact the evidence evaluated for that control. However, a strong control environment would not eliminate the need to evaluate the operation of the control in some manner.

#### **b. Implementing Procedures to Evaluate Evidence of the Operation of ICFR**

Management should evaluate evidence that provides a reasonable basis for its assessment of the operating effectiveness of the controls identified in Section II.A.1. Management uses its assessment of ICFR risk, as determined in Section II.A.2 to

determine the evaluation methods and procedures necessary to obtain sufficient evidence. The evaluation methods and procedures may be integrated with the daily responsibilities of its employees or implemented specifically for purposes of the ICFR evaluation. Activities that are performed for other reasons (for example, day-to-day activities to manage the operations of the business) may also provide relevant evidence. Further, activities performed to meet the monitoring objectives of the control framework may provide evidence to support the assessment of the operating effectiveness of ICFR.

The evidence management evaluates comes from direct tests of controls, on-going monitoring, or a combination of both. Direct tests of controls are tests ordinarily performed on a periodic basis by individuals with a high degree of objectivity relative to the controls being tested. Direct tests provide evidence as of a point in time and may provide information about the reliability of on-going monitoring activities. On-going monitoring includes management's normal, recurring activities that provide information about the operation of controls. These activities include, for example, self-assessment<sup>43</sup> procedures and procedures to analyze performance measures designed to track the operation of controls.<sup>44</sup> Self-assessment is a broad term that can refer to different types of procedures performed by individuals with varying degrees of objectivity. It includes assessments made by the personnel who operate the control as well as members of management who are not responsible for operating the control. The evidence provided

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<sup>43</sup> For example, COSO's 1992 framework defines self-assessments as "evaluations where persons responsible for a particular unit or function will determine the effectiveness of controls for their activities."

<sup>44</sup> Management's evaluation process may also consider the results of key performance indicators ("KPIs") in which management reconciles operating and financial information with its knowledge of the business. The procedures that management implements pursuant to this section should evaluate the effective operation of these KPI-type controls when they are identified pursuant to Section II.A.1.b. as addressing financial reporting risk.

by self-assessment activities depends on the personnel involved and the manner in which the activities are conducted. For example, evidence from self-assessments performed by personnel responsible for operating the control generally provides less evidence due to the evaluator's lower degree of objectivity.

As the ICFR risk increases, management will ordinarily adjust the nature of the evidence that is obtained. For example, management can increase the evidence from on-going monitoring activities by utilizing personnel who are more objective and/or increasing the extent of validation through periodic direct testing of the underlying controls. Management can also vary the evidence obtained by adjusting the period of time covered by direct testing. When ICFR risk is assessed as high, the evidence management obtains would ordinarily consist of direct testing or on-going monitoring activities performed by individuals who have a higher degree of objectivity. In situations where a company's on-going monitoring activities utilize personnel who are not adequately objective, the evidence obtained would normally be supplemented with direct testing by those who are independent from the operation of the control. In these situations, direct testing of controls corroborates evidence from on-going monitoring activities as well as evaluates the operation of the underlying controls and whether they continue to adequately address financial reporting risks. When ICFR risk is assessed as low, management may conclude that evidence from on-going monitoring is sufficient and that no direct testing is required. Further, management's evaluation would ordinarily consider evidence from a reasonable period of time during the year, including the fiscal year-end.

In smaller companies, management's daily interaction with its controls may provide it with sufficient knowledge about their operation to evaluate the operation of ICFR. Knowledge from daily interaction includes information obtained by on-going direct involvement with and direct supervision of the execution of the control by those responsible for the assessment of the effectiveness of ICFR. Management should consider its particular facts and circumstances when determining whether its daily interaction with controls provides sufficient evidence to evaluate the operating effectiveness of ICFR. For example, daily interaction may be sufficient when the operation of controls is centralized and the number of personnel involved is limited. Conversely, daily interaction in companies with multiple management reporting layers or operating segments would generally not provide sufficient evidence because those responsible for assessing the effectiveness of ICFR would not ordinarily be sufficiently knowledgeable about the operation of the controls. In these situations, management would ordinarily utilize direct testing or on-going monitoring-type evaluation procedures to obtain reasonable support for the assessment.

Management evaluates the evidence it gathers to determine whether the operation of a control is effective. This evaluation considers whether the control operated as designed. It also considers matters such as how the control was applied, the consistency with which it was applied, and whether the person performing the control possesses the necessary authority and competence to perform the control effectively. If management determines that the operation of the control is not effective, a deficiency exists that must be evaluated to determine whether it is a material weakness.

### **c. Evidential Matter to Support the Assessment**

Management's assessment must be supported by evidential matter that provides reasonable support for its assessment. The nature of the evidential matter may vary based on the assessed level of ICFR risk of the underlying controls and other circumstances. Reasonable support for an assessment would include the basis for management's assessment, including documentation of the methods and procedures it utilizes to gather and evaluate evidence.

The evidential matter may take many forms and will vary depending on the assessed level of ICFR risk for controls over each of its financial reporting elements. For example, management may document its overall strategy in a comprehensive memorandum that establishes the evaluation approach, the evaluation procedures, the basis for management's conclusion about the effectiveness of controls related to the financial reporting elements and the entity-level and other pervasive elements that are important to management's assessment of ICFR.

If management determines that the evidential matter within the company's books and records is sufficient to provide reasonable support for its assessment, it may determine that it is not necessary to separately maintain copies of the evidence it evaluates. For example, in smaller companies, where management's daily interaction with its controls provides the basis for its assessment, management may have limited documentation created specifically for the evaluation of ICFR. However, in these instances, management should consider whether reasonable support for its assessment would include documentation of how its interaction provided it with sufficient evidence.

This documentation might include memoranda, e-mails, and instructions or directions to and from management to company employees.

Further, in determining the nature of supporting evidential matter, management should also consider the degree of complexity of the control, the level of judgment required to operate the control, and the risk of misstatement in the financial reporting element that could result in a material misstatement of the financial statements. As these factors increase, management may determine that evidential matter supporting the assessment should be separately maintained. For example, management may decide that separately maintained documentation in certain areas will assist the audit committee in exercising its oversight of the company's financial reporting.

The evidential matter constituting reasonable support for management's assessment would ordinarily include documentation of how management formed its conclusion about the effectiveness of the company's entity-level and other pervasive elements of ICFR that its applicable framework describes as necessary for an effective system of internal control.

### **3. Multiple Location Considerations**

Management's consideration of financial reporting risks generally includes all of its locations or business units.<sup>45</sup> Management may determine that financial reporting risks are adequately addressed by controls which operate centrally, in which case the evaluation approach is similar to that of a business with a single location or business unit. When the controls necessary to address financial reporting risks operate at more than one

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<sup>45</sup> Consistent with the guidance in Section II.A.1., management may determine when identifying financial reporting risks that some locations are so insignificant that no further evaluation procedures are needed.



location or business unit, management would generally evaluate evidence of the operation of the controls at the individual locations or business units.

Management may determine that the ICFR risk of the controls (as determined through Section II.A.2.a) that operate at individual locations or business units is low. In such situations, management may determine that evidence gathered through self-assessment routines or other on-going monitoring activities, when combined with the evidence derived from a centralized control that monitors the results of operations at individual locations, constitutes sufficient evidence for the evaluation. In other situations, management may determine that, because of the complexity or judgment in the operation of the controls at the individual location, the risk that controls will fail to operate is high, and therefore more evidence is needed about the effective operation of the controls at the location.

Management should generally consider the risk characteristics of the controls for each financial reporting element, rather than making a single judgment for all controls at that location when deciding whether the nature and extent of evidence is sufficient. When performing its evaluation of the risk characteristics of the controls identified, management should consider whether there are location-specific risks that might impact the risk that a control might fail to operate effectively. Additionally, there may be pervasive risk factors that exist at a location that cause all controls, or a majority of controls, at that location to be considered higher risk.

## **B. Reporting Considerations**

### **1. Evaluation of Control Deficiencies**

In order to determine whether a control deficiency, or combination of control deficiencies, is a material weakness, management evaluates the severity of each control deficiency that comes to its attention. Control deficiencies that are determined to be a material weakness must be disclosed in management's annual report on its assessment of the effectiveness of ICFR. Control deficiencies that are considered to be significant deficiencies are reported to the company's audit committee and the external auditor pursuant to management's compliance with the certification requirements in Exchange Act Rule 13a-14.<sup>46</sup>

Management may not disclose that it has assessed ICFR as effective if one or more deficiencies in ICFR are determined to be a material weakness. As part of the evaluation of ICFR, management considers whether each deficiency, individually or in combination, is a material weakness as of the end of the fiscal year. Multiple control deficiencies that affect the same financial statement amount or disclosure increase the likelihood of misstatement and may, in combination, constitute a material weakness if there is a reasonable possibility<sup>47</sup> that a material misstatement of the financial statements

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<sup>46</sup> Pursuant to Exchange Act Rules 13a-14 and 15d-14 [17 CFR 240.13a-14 and 240.15d-14], management discloses to the auditors and to the audit committee of the board of directors (or persons fulfilling the equivalent function) all material weaknesses and significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize and report financial data. The term "material weakness" is defined in the Commission's rules in Exchange Act Rule 12b-2 and Rule 1-02 of Regulation S-X. See Release No. 34-55928. The Commission is seeking additional comment on the definition of the term "significant deficiency" in the Commission's rules in Exchange Act Rule 12b-2 and Rule 1-02 of Regulation S-X. See Release No. 34-55930.

<sup>47</sup> There is a reasonable possibility of an event when the likelihood of the event is either "reasonably possible" or "probable" as those terms are used in Financial Accounting Standards Board Statement No. 5, Accounting for Contingencies. The use of the phrase "reasonable

would not be prevented or detected in a timely manner, even though such deficiencies may be individually less severe than a material weakness. Therefore, management should evaluate individual control deficiencies that affect the same financial statement amount or disclosure, or component of internal control, to determine whether they collectively result in a material weakness.

The evaluation of the severity of a control deficiency should include both quantitative and qualitative factors. Management evaluates the severity of a deficiency in ICFR by considering whether there is a reasonable possibility that the company's ICFR will fail to prevent or detect a misstatement of a financial statement amount or disclosure; and the magnitude of the potential misstatement resulting from the deficiency or deficiencies. The severity of a deficiency in ICFR does not depend on whether a misstatement actually has occurred but rather on whether there is a reasonable possibility that the company's ICFR will fail to prevent or detect a misstatement on a timely basis.

Risk factors affect whether there is a reasonable possibility<sup>48</sup> that a deficiency, or a combination of deficiencies, will result in a misstatement of a financial statement amount or disclosure. These factors include, but are not limited to, the following:

- The nature of the financial reporting elements involved (for example, suspense accounts and related party transactions involve greater risk);

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possibility that a material misstatement of the financial statements would not be prevented or detected in a timely manner” is intended solely to assist management in identifying matters for disclosure under Item 308 of Regulation S-K. It is not intended to interpret or describe management's responsibility under the FCPA or modify a control framework's definition of what constitutes an effective system of internal control.

<sup>48</sup> The evaluation of whether a deficiency in ICFR presents a reasonable possibility of misstatement can be made without quantifying the probability of occurrence as a specific percentage or range.

- The susceptibility of the related asset or liability to loss or fraud (that is, greater susceptibility increases risk);
- The subjectivity, complexity, or extent of judgment required to determine the amount involved (that is, greater subjectivity, complexity, or judgment, like that related to an accounting estimate, increases risk);
- The interaction or relationship of the control with other controls, including whether they are interdependent or redundant;
- The interaction of the deficiencies (that is, when evaluating a combination of two or more deficiencies, whether the deficiencies could affect the same financial statement amounts or disclosures); and
- The possible future consequences of the deficiency.

Factors that affect the magnitude of the misstatement that might result from a deficiency or deficiencies in ICFR include, but are not limited to, the following:

- The financial statement amounts or total of transactions exposed to the deficiency; and
- The volume of activity in the account balance or class of transactions exposed to the deficiency that has occurred in the current period or that is expected in future periods.

In evaluating the magnitude of the potential misstatement, the maximum amount that an account balance or total of transactions can be overstated is generally the recorded amount, while understatements could be larger. Also, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement.

Management should evaluate the effect of compensating controls<sup>49</sup> when determining whether a control deficiency or combination of deficiencies is a material weakness. To have a mitigating effect, the compensating control should operate at a level of precision that would prevent or detect a misstatement that could be material.

In determining whether a deficiency or a combination of deficiencies represents a material weakness, management considers all relevant information. Management should evaluate whether the following situations indicate a deficiency in ICFR exists and, if so, whether it represents a material weakness:

- Identification of fraud, whether or not material, on the part of senior management;<sup>50</sup>
- Restatement of previously issued financial statements to reflect the correction of a material misstatement;<sup>51</sup>
- Identification of a material misstatement of the financial statements in the current period in circumstances that indicate the misstatement would not have been detected by the company's ICFR; and
- Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.

When evaluating the severity of a deficiency, or combination of deficiencies, in ICFR, management also should determine the level of detail and degree of assurance that

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<sup>49</sup> Compensating controls are controls that serve to accomplish the objective of another control that did not function properly, helping to reduce risk to an acceptable level.

<sup>50</sup> For purposes of this indicator, the term "senior management" includes the principal executive and financial officers signing the company's certifications as required under Section 302 of Sarbanes Oxley as well as any other members of senior management who play a significant role in the company's financial reporting process.

<sup>51</sup> See FAS 154, Accounting Changes and Error Corrections, regarding correction of a misstatement.

would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP. If management determines that the deficiency, or combination of deficiencies, might prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP, then management should treat the deficiency, or combination of deficiencies, as an indicator of a material weakness.

## **2. Expression of Assessment of Effectiveness of ICFR by Management**

Management should clearly disclose its assessment of the effectiveness of ICFR and, therefore, should not qualify its assessment by stating that the company's ICFR is effective subject to certain qualifications or exceptions. For example, management should not state that the company's controls and procedures are effective except to the extent that certain material weakness(es) have been identified. In addition, if a material weakness exists, management may not state that the company's ICFR is effective. However, management may state that controls are ineffective for specific reasons.

## **3. Disclosures about Material Weaknesses**

The Commission's rule implementing Section 404 was intended to bring information about material weaknesses in ICFR into public view. Because of the significance of the disclosure requirements surrounding material weaknesses beyond specifically stating that the material weaknesses exist, companies should also consider including the following in their disclosures:<sup>52</sup>

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<sup>52</sup> Significant deficiencies in ICFR are not required to be disclosed in management's annual report on its evaluation of ICFR required by Item 308(a).

- The nature of any material weakness,
- Its impact on the company's financial reporting and its ICFR, and
- Management's current plans, if any, or actions already undertaken, for remediating the material weakness.

Disclosure of the existence of a material weakness is important, but there is other information that also may be material and necessary to form an overall picture that is not misleading.<sup>53</sup> The goal underlying all disclosure in this area is to provide an investor with disclosure and analysis that goes beyond describing the mere existence of a material weakness. There are many different types of material weaknesses and many different factors that may be important to the assessment of the potential effect of any particular material weakness. While management is required to conclude and state in its report that ICFR is ineffective when there are one or more material weaknesses, companies should also consider providing disclosure that allows investors to understand the cause of the control deficiency and to assess the potential impact of each particular material weakness. This disclosure will be more useful to investors if management differentiates the potential impact and importance to the financial statements of the identified material weaknesses, including distinguishing those material weaknesses that may have a pervasive impact on ICFR from those material weaknesses that do not.

#### **4. Impact of a Restatement of Previously Issued Financial Statements on Management's Report on ICFR**

Item 308 of Regulation S-K requires disclosure of management's assessment of the effectiveness of the company's ICFR as of the end of the company's most recent fiscal year. When a material misstatement of previously issued financial statements is

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<sup>53</sup> See Exchange Act Rule 12b-20 [17 CFR 240.12b-20].

discovered, a company is required to restate those financial statements. However, the restatement of financial statements does not, by itself, necessitate that management consider the effect of the restatement on the company's prior conclusion related to the effectiveness of ICFR.

While there is no requirement for management to reassess or revise its conclusion related to the effectiveness of ICFR, management should consider whether its original disclosures are still appropriate and should modify or supplement its original disclosure to include any other material information that is necessary for such disclosures not to be misleading in light of the restatement. The company should also disclose any material changes to ICFR, as required by Item 308(c) of Regulation S-K.

Similarly, while there is no requirement that management reassess or revise its conclusion related to the effectiveness of its disclosure controls and procedures, management should consider whether its original disclosures regarding effectiveness of disclosure controls and procedures need to be modified or supplemented to include any other material information that is necessary for such disclosures not to be misleading. With respect to the disclosures concerning ICFR and disclosure controls and procedures, the company may need to disclose in this context what impact, if any, the restatement has on its original conclusions regarding effectiveness of ICFR and disclosure controls and procedures.

## **5. Inability to Assess Certain Aspects of ICFR**

In certain circumstances, management may encounter difficulty in assessing certain aspects of its ICFR. For example, management may outsource a significant process to a service organization and determine that evidence of the operating



effectiveness of the controls over that process is necessary. However, the service organization may be unwilling to provide either a Type 2 SAS 70 report or to provide management access to the controls in place at the service organization so that management could assess effectiveness.<sup>54</sup> Finally, management may not have compensating controls in place that allow a determination of the effectiveness of the controls over the process in an alternative manner. The Commission's disclosure requirements state that management's annual report on ICFR must include a statement as to whether or not ICFR is effective and do not permit management to issue a report on ICFR with a scope limitation.<sup>55</sup> Therefore, management must determine whether the inability to assess controls over a particular process is significant enough to conclude in its report that ICFR is not effective.

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<sup>54</sup> AU Sec. 324, Service Organizations (as adopted on an interim basis by the Public Company Accounting Oversight Board ("PCAOB") in PCAOB Rule 3200T), defines a report on controls placed in operation and test of operating effectiveness, commonly referred to as a "Type 2 SAS 70 report." This report is a service auditor's report on a service organization's description of the controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements, on whether such controls were suitably designed to achieve specified control objectives, on whether they had been placed in operation as of a specific date, and on whether the controls that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified.

<sup>55</sup> See Item 308(a)(3) of Regulations S-K and S-B [17 CFR 229.308(a)(3) and 228.308(a)(3)].

### III. Discussion of Comments on the Proposing Release

The Proposing Release proposed for public comment interpretive guidance for management regarding the annual evaluation of ICFR required by Rules 13a-15(c) and 15d-15(c) under the Exchange Act. We received letters from 211 commenters in response to the Proposing Release.<sup>56</sup> The majority of commenters were supportive of the Commission's efforts in developing this Interpretive Guidance. We have reviewed and considered all of the comments received on the proposal, and we discuss our conclusions with respect to the comments in more detail in the following sections.

#### A. Alignment between Management's Evaluation and Assessment and the External Audit

Commenters expressed concern that confusion and inefficiencies may arise from differences between the proposed guidance for management's evaluation of ICFR and the PCAOB's proposed auditing standard for ICFR.<sup>57</sup> Commenters cited a lack of alignment between the two with regard to the terminology and definitions used<sup>58</sup> as well as

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<sup>56</sup> Of the 211 commenters, 43 were issuers, 33 professional associations and business groups, 19 foreign private issuers and foreign professional associations, 10 investor advocacy and other similar groups, 8 major accounting firms, 11 smaller accounting firms and Section 404 service providers, 8 banks and banking associations, 4 law firms and law associations, and 75 other interested parties including students, academics, and other individuals. The comment letters are available for inspection in the Commission's Public Reference Room at 100 F Street, NE, Washington DC 20549 in File No. S7-24-06, or may be viewed at <http://www.sec.gov/comments/s7-24-06/s72406.shtml>.

<sup>57</sup> In PCAOB Release No. 2006-007 the PCAOB proposed for public comment An Audit of Internal Control Over Financial Reporting That Is Integrated With An Audit of Financial Statements and Considering and Using the Work of Others in an Audit. See [http://www.pcaobus.org/Rules/Docket\\_021/2006-12-19\\_Release\\_No.\\_2006-007.pdf](http://www.pcaobus.org/Rules/Docket_021/2006-12-19_Release_No._2006-007.pdf) (hereinafter "Proposed Auditing Standard").

<sup>58</sup> See, for example, letters from American Bar Association's Committees on Federal Regulation of Securities and Law and Accounting of the Section of Business Law (ABA), Association of Chartered Certified Accountants (ACCA), Edison Electric Institute (EEI), European Federation of Accountants (FEE), Financial Executives International Committee on Corporate Reporting (FEI CCR), Frank Gorrell (F. Gorrell), Society of Corporate Secretaries and Governance Professionals, and The Institute of Chartered Accountants in England and Wales (ICAEW).

differences in the overall approach. Some commenters that were supportive of the principles-based approach to the proposed interpretive guidance expressed concern that improvements in the efficiency of management's evaluation of ICFR would be limited by what they viewed as comparatively more prescriptive guidance for external auditors in the Proposed Auditing Standard.<sup>59</sup> Other commenters suggested that maximizing their auditor's ability to rely on the work performed in management's evaluation would require aligning the evaluation approach for management with the Proposed Auditing Standard.<sup>60</sup> Even so, some of these commenters still viewed the interpretive guidance as an improvement because it provides management the ability to choose whether, and to what extent, it should align its evaluation with the auditing standard; whereas commenters said that management feels compelled to align with the auditing standard under the current rules. Other commenters suggested that the proposed interpretive guidance was compatible with the Proposed Auditing Standard and that improvements in implementation could be attained with close coordination between management and auditors.<sup>61</sup>

In response to the comment letters, we have revised our proposal to more closely align it with how we anticipate the PCAOB will revise its proposed auditing standard.

For example, the definition of a material weakness and the related guidance for

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<sup>59</sup> See, for example, letters from Eli Lilly and Company (Eli Lilly), FEI CCR, Hutchinson Technology Inc. (Hutchinson), Independent Community Bankers of America (ICBA), MetLife Inc. (MetLife), Procter & Gamble Company (P&G), and Supervalu Inc. (Supervalu).

<sup>60</sup> See, for example, letters from Heritage Financial Corporation and Southern Company.

<sup>61</sup> See, for example, letters from BDO Seidman LLP (BDO), McGladrey & Pullen LLP (M&P), and PricewaterhouseCoopers LLP (PwC).

evaluating deficiencies, including indicators of a material weakness, have been revised.<sup>62</sup> In addition, alignment revisions were made to the guidance for evaluating whether controls adequately address financial reporting risks, including entity-level controls, the factors to consider when identifying financial reporting risks and the factors for assessing the risk associated with individual financial reporting elements and controls.

However, some differences between our final interpretive guidance for management and the PCAOB's audit standard remain. These differences are not necessarily contradictions or misalignment; rather they reflect the fact that management and the auditor have different roles and responsibilities with respect to evaluating and auditing ICFR. Management is responsible for designing and maintaining ICFR and performing an evaluation annually that provides it with a reasonable basis for its assessment as to whether ICFR is effective as of fiscal year-end. Management's daily involvement with its internal control system provides it with knowledge and information that may influence its judgments about how best to conduct the evaluation and the sufficiency of evidence it needs to assess the effectiveness of ICFR. In contrast, the auditor is responsible for conducting an independent audit that includes appropriate professional skepticism. Moreover, the audit of ICFR is integrated with the audit of the company's financial statements. While there is a close relationship between the work performed by management and its auditor, the ICFR audit will not necessarily be limited to the nature and extent of procedures management has already performed as part of its evaluation of ICFR. There will be differences in the approaches used by management and the auditor because the auditor does not have the same information and

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<sup>62</sup> The revisions made to the proposed definition of material weakness and the related guidance, including the strong indicators, are discussed in Section III.F. of this document.

understanding as management and because the auditor will need to integrate its tests of ICFR with the financial statement audit. We agree with those commenters that suggested coordination between management and auditors on their respective efforts will ensure that both the evaluation by management and the independent audit are completed in an efficient and effective manner.

## **B. Principles-based Nature of Guidance for Conducting the Evaluation**

The guidance is intended to assist management in complying with two broad principles: (1) evaluate whether controls have been implemented to adequately address the risk that a material misstatement of the financial statements would not be prevented or detected in a timely manner and (2) evaluate evidence about the operation of controls based on an assessment of risk. We believe the guidance will enable companies of all sizes and complexities to comply with our rules effectively and efficiently.

Commenters expressed support for the proposed guidance's principles-based approach.<sup>63</sup> However, some requested that the proposal be revised to include additional guidance and illustrative examples in the following areas:<sup>64</sup>

- the identification of controls that address financial reporting risks;<sup>65</sup>
- the assessment of ICFR risk, including how evidence gained over prior periods should impact management's assessment of risks associated with

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<sup>63</sup> See, for example, letters from ACE Limited (ACE), American Electric Power Company, Inc. (AEP), Business Roundtable (BR), Canadian Bankers Association, Center for Audit Quality (Center), Ernst & Young LLP (EY), Grant Thornton LLP (GT), ING Groep N.V. (ING), Manulife Financial (Manulife), PwC, P&G, and Reznick Group, P.C. (Reznick).

<sup>64</sup> See, for example, letters from Brown-Forman, Ford Motor Company, MasterCard Incorporated (MasterCard), Northrop Grumman Corporation, Supervalu, UFP Technologies (UFP), and UnumProvident Corporation (UnumProvident).

<sup>65</sup> See, for example, letter from Nina Stofberg (N. Stofberg).

controls identified and therefore, the evidence needed to support its assessment;<sup>66</sup>

- how varying levels of risk impact the nature of the evidence necessary to support its assessment;<sup>67</sup>
- when on-going monitoring activities, including self-assessments, could be used to support management's assessment and reduce direct testing;<sup>68</sup>
- sampling techniques, sample sizes, and testing methods;<sup>69</sup>
- the type and manner in which supporting evidence should be maintained;<sup>70</sup> including specific guidelines regarding the amount, form and medium of evidence;<sup>71</sup> and
- how management should document the effectiveness of monitoring activities utilized to support its assessment, as well as how management should support the evidence obtained from its daily interaction with controls as part of its assessment.<sup>72</sup>

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<sup>66</sup> See, for example, letters from ISACA and IT Governance Institute (ISACA), Manulife, and Ohio Society of Certified Public Accountants (Ohio).

<sup>67</sup> See, for example, letters from Cardinal Health, Inc. (Cardinal), Cleary Gottlieb Steen & Hamilton LLP (Cleary), and ISACA.

<sup>68</sup> See, for example, letters from BASF Aktiengesellschaft (BASF), Cardinal, Computer Sciences Corporation (CSC), ING, ISACA, Ohio, PPL Corporation (PPL), R. Malcolm Schwartz, N. Stofberg, and UnumProvident.

<sup>69</sup> See, for example, letters from BDO, National Association of Real Estate Investment Trusts, Reznick, and UFP.

<sup>70</sup> See, for example, letters from AEP, BDO, Center, EEI, Frank Consulting, PLLP (Frank), The Hundred Group of Finance Directors (100 Group), Institut Der Wirtschaftsprüfer [Institute of Public Auditors in Germany] (IDW), Managed Funds Association (MFA), Nasdaq Stock Market, Inc. (Nasdaq), Ohio, N. Stofberg, and UFP.

<sup>71</sup> See, for example, letter from Nasdaq.

<sup>72</sup> See, for example, letters from BDO and Center.

We have considered the requests for additional guidance and decided to retain the principles-based nature of the proposed guidance. We believe an evaluation of ICFR will be most effective and efficient when management makes use of all available facts and information to make reasonable judgments about the evaluation methods and procedures that are necessary to have a reasonable basis for the assessment of the effectiveness of ICFR and the evidential matter maintained in support of the assessment. Additional guidance and examples in the areas requested would likely have the negative consequence of establishing “bright line” or “one-size fits all” evaluation approaches. Such an outcome would be contrary to our view that the evaluations must be tailored to a company’s individual facts and circumstances to be both effective and efficient. Moreover, an evaluation by management that is focused on compliance with detailed guidance, rather than the risks to the reliability of its financial reporting, would likely lead to evaluations that are inefficient, ineffective or both.

Detailed guidance and examples from the Commission may also limit or hinder the natural evolution and further development of control frameworks and evaluation methodologies as technology, control systems, and financial reporting evolve. As we have previously stated, the Commission supports and encourages the further development of control frameworks and related implementation guidance. For example, the July 2006 small business guidance issued by COSO addresses the identification of financial reporting risks and the related controls. Additionally, we note that COSO is currently working on a project to further define how the effectiveness of control systems can be

monitored.<sup>73</sup> As such, companies may find that there are other sources for the additional guidance in the areas they are seeking.

Commenters also expressed the view that companies may abuse the flexibility afforded by the proposed principles-based guidance to perform inadequate evaluations, thereby undermining the intended investor protection benefits.<sup>74</sup> Other commenters have observed that material weakness disclosures to investors are too often simultaneous with, rather than in advance of, the restatement of financial statements, which undermines the usefulness of the disclosures.<sup>75</sup> In response to these comments, we note that this principles-based guidance enables management to tailor its evaluation so that it focuses on those areas of financial reporting that pose the highest risk to reliable financial reporting. We believe that a tailored evaluation approach that focuses resources on areas of highest risk will improve, rather than degrade, the effectiveness of many company's evaluations and improve the timeliness of material weakness disclosures to investors.

### **C. Scalability and Small Business Considerations**

Commenters believed that the proposed interpretive guidance can be scaled to companies of all sizes and will benefit smaller public companies in completing their

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<sup>73</sup> In a press release on January 8, 2007, COSO announced that Grant Thornton LLP had been commissioned to develop guidance to help organizations monitor the quality of their internal control systems. According to that press release, the guidance will serve as a tool for effectively monitoring internal controls while complying with Sarbanes-Oxley. The press release is available at [http://www.coso.org/Publications/COSO%20Monitoring%20GT%20Final%20Release\\_1.8.07.pdf](http://www.coso.org/Publications/COSO%20Monitoring%20GT%20Final%20Release_1.8.07.pdf).

<sup>74</sup> See, for example, letters from Joseph V. Carcello, Consumer Federation of America, Consumer Action, U.S. Public Interest Research Group (CFA), and Moody's Investors Service (Moody's).

<sup>75</sup> See, for example, letters from CFA and Moody's.



assessments.<sup>76</sup> However, some commenters requested more guidance to enable them to conduct the evaluation in an effective and efficient manner. For example, commenters requested more guidance on how some of the unique characteristics of smaller companies, including a lack of segregation of duties, should be considered in the evaluation.<sup>77</sup>

Other commenters, mostly comprised of investor groups, requested that the guidance emphasize that scaled or tailored evaluation methods and procedures for smaller public companies should be based on both the size and complexity of the business and do not imply less rigorous evaluation methods and procedures.<sup>78</sup>

Some commenters indicated that smaller public companies should continue to be exempt at least until a thorough examination is conducted of both the Interpretive Guidance and the new Auditing Standard to ensure that smaller companies are not disproportionately burdened.<sup>79</sup> Some commenters requested that the SEC further delay

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<sup>76</sup> See, for example, letters from American Bankers Association (American Bankers), Anthony S. Chan, Chandler (U.S.A.), Inc. (Chandler), CNB Corporation & Citizens National Bank of Cheboygan (CNB), Financial Services Forum, GT, Greater Boston Chamber of Commerce, Minn-Dak Farmers Cooperative (MDFC), RAM Energy Resources, Inc., and San Jose Water Company.

<sup>77</sup> See, for example, letters from American Electronics Association (AeA), EY, Financial Executives International Small Public Company Task Force (FEI SPCTF), Frank, Institute of Management Accountants (IMA), MFA, U.S. Chamber of Commerce (Chamber), and U.S. Small Business Administration's Office of Advocacy (SBA).

<sup>78</sup> See, for example, letters from California Public Employees' Retirement System (CalPERS), CFA, Council of Institutional Investors, Ethics Resource Center, International Brotherhood of Teamsters, and Pension Reserves Investment Management Board (PRIMB).

<sup>79</sup> See, for example, letters from AeA, Biotechnology Industry Organization, Committee on Capital Markets Regulation (CCMR), Financial Reporting Committee of the Association of the Bar of the City of New York (NYC Bar), International Association of Small Broker Dealers and Advisers, National Venture Capital Association, SBA, Silicon Valley Leadership Group (SVLG), Small Business Entrepreneurship Council, TechNet, and Telecommunications Industry Association.

the implementation for one additional year<sup>80</sup> or continued to call for a complete exemption from Section 404 for smaller public companies.<sup>81</sup> Other commenters requested that smaller public companies not be exempted.<sup>82</sup>

We believe the principles-based guidance permits flexible and scalable evaluation approaches that will enable management of smaller public companies to evaluate and assess the effectiveness of ICFR without undue cost burdens. The guidance recognizes that internal control systems and the methods and procedures necessary to evaluate their effectiveness may be different in smaller public companies than in larger companies. However, the flexibility provided in the guidance is not meant to imply that evaluations for smaller public companies be conducted with less rigor, or to provide anything less than reasonable assurance as to the effectiveness of ICFR at such companies. Rather, smaller public companies should utilize the flexibility provided in the guidance to cost-effectively tailor and scale their methods and approaches for identifying and documenting financial reporting risks and the related controls and for evaluating whether operation of controls is effective (for example, by utilizing evidence gathered through management's daily interaction with its controls), so that they provide the evidence needed to assess whether ICFR is effective.

In addition, as previously mentioned, companies may find that there are other sources for guidance, such as the July 2006 guidance for applying the COSO framework to smaller public companies. We believe our guidance, when used in conjunction with

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<sup>80</sup> See, for example, letters from American Bankers, America's Community Bankers, Chandler, CNB, FEI SPCTF, F. Gorrell, ICBA, MFA, and Washington Legal Foundation (WLF).

<sup>81</sup> See, for example, letters from American Stock Exchange, ICBA, UFP, and WLF.

<sup>82</sup> See, for example, letters from American Federation of Labor and Congress of Industrial Organizations (AFL-CIO), CalPERS, Frank, F. Gorrell, PRIMB, and WithumSmith+Brown Global Assurance, LLC.

other such guidance, will enable smaller public companies to have a better understanding of the requirements of a control framework, its role in effective internal control systems and the relationship to our evaluation and disclosure requirements. This should enable management to plan and conduct its evaluation in an effective and efficient manner.

The Commission believes that compliance with the ICFR evaluation and assessment requirements by smaller public companies will further the primary goal of Sarbanes-Oxley which is to enhance the quality of financial reporting and increase investor confidence in the fairness and integrity of the securities markets. We note that all financial statements filed with the Commission, even those by smaller public companies, result from a system of internal controls. Such systems are required by the FCPA to operate at a level that provides “reasonable assurance” about the reliability of financial reporting. Our rules implementing Section 404 direct management of all companies to evaluate and assess whether the company’s system of internal controls is effective at achieving reasonable assurance. Our guidance is intended to help them do so in a cost-effective manner. Given the principles-based nature of our guidance and the flexibility it provides, we do not believe further postponement of the evaluation requirements are needed for smaller companies. We believe that the timing of the issuance of the Interpretive Guidance is adequate to allow for its effective implementation in 2007 evaluations.

#### **D. Identifying Financial Reporting Risks and Controls**

##### **1. Summary of the Proposal**

The proposal directed management to consider the sources and potential likelihood of misstatements, including those arising from fraudulent activity, and identify

those that could result in a material misstatement of the financial statements (that is, financial reporting risks). The proposal indicated that management's consideration of the risk of misstatement generally includes all of its locations or business units and that the methods and procedures for identifying financial reporting risks will vary based on the characteristics of the individual company. The proposal discussed factors for management to consider in selecting methods and procedures for evaluating financial reporting risks and in identifying the sources and potential likelihood of misstatement.

The proposal directed management to evaluate whether controls were placed in operation to adequately address the financial reporting risks it identifies. The proposal indicated that controls were not adequate when their design was such that there was a reasonable possibility that a misstatement in a financial reporting element that could result in a material misstatement of the financial statements would not be prevented or detected in a timely manner. The proposal discussed the fact that some controls may be automated or may depend upon IT functionality. In these situations, the proposal stated that management's evaluation should consider not only the design and operation of the automated or IT dependent controls, but also the aspects of IT general controls necessary to adequately address financial reporting risks.

The proposal also indicated that entity-level controls should be considered when identifying financial reporting risks and related controls for a financial reporting element. The proposal discussed the nature of entity-level controls, how they relate to a financial reporting element and the need to consider whether they would prevent or detect material misstatements. If a financial reporting risk for a financial reporting element is adequately addressed by an entity-level control, the proposal indicated that no further controls

needed to be identified and tested by management for purposes of the evaluation of ICFR.

## **2. Comments on the Proposal and Revisions Made**

The Commission received a number of comments on the proposed guidance for identifying financial reporting risks and controls. As discussed in Section III.B above, many of these commenters requested more examples or more detailed guidance. Other comments received related to the identification of fraud risks and related controls; entity-level controls; and IT general controls.

### Identification of fraud risks and related controls

Commenters suggested the guidance be revised to more strongly emphasize management's responsibility to identify and evaluate fraud risks and the related controls that address those risks.<sup>83</sup> Commenters also discussed the nature of fraud risks that most often lead to materially misstated financial statements and requested additional guidance regarding which fraud related controls are within the scope of the evaluation;<sup>84</sup> whether management can consider the risk of fraud through the overall risk assessment or if a specific fraud threat analysis is required;<sup>85</sup> and examples of the types of fraud that should be considered.<sup>86</sup> Other commenters noted that there is existing guidance for management, beyond what was referenced in the proposal, for assessing fraud risks and

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<sup>83</sup> See, for example, letters from ACE, ACCA, BDO, Center, CSC, Deloitte & Touche LLP (Deloitte), GT, IMA, KPMG LLP (KPMG), M&P, Moody's, and PwC.

<sup>84</sup> See, for example, letters from BASF, BDO, and GT.

<sup>85</sup> See, for example, letter from Tatum LLC (Tatum).

<sup>86</sup> See, for example, letters from FEI CCR, P&G, and N. Stoffberg.

the related controls. These commenters suggested that the proposal be revised to directly incorporate the most relevant elements of such guidance.<sup>87</sup>

In response to the comments, the proposal was revised to clarify that fraud risks are expected to exist at every company and that the nature and extent of the fraud risk assessment activities should be commensurate with the size and complexity of the company. Additionally, we expanded the references to existing guidance to include the AICPA's 2005 Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention and COSO's July 2006 Guidance for Smaller Public Companies. Given the availability of existing information and guidance on fraud and consistent with the principles-based nature of the interpretive guidance, we determined that it was unnecessary to provide a list of fraud risks expected to be present at every company or a list of the areas of financial reporting expected to have a risk of material misstatement due to fraud. Moreover, providing such a list may result in a "checklist" type approach to fraud risk assessments that would likely be ineffective as financial reporting changes over time, or given the wide variety of facts and circumstances that exist in different companies and industries. While management may find such checklists a useful starting point, effective fraud risk assessments will require sound and thoughtful judgments that reflect a company's individual facts and circumstances.

#### Entity-Level Controls

Commenters requested further clarification of how entity-level controls can address financial reporting risks in a top-down, risk based approach.<sup>88</sup> Commenters also

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<sup>87</sup> See, for example, letters from Center, GT, KPMG, and M&P.

<sup>88</sup> See, for example, letters from EY, Frank, MetLife, and UnumProvident.

suggested that the guidance place more emphasis on entity-level controls given their pervasive impact on all other aspects of ICFR.<sup>89</sup>

In response to the comments received, we expanded the discussion of entity-level controls and how they relate to financial reporting elements. This discussion further clarifies that some entity-level controls, such as controls within the control environment, have an important, but indirect, effect on the likelihood that a misstatement will be prevented or detected on a timely basis. While these controls might affect the other controls management determines are necessary to address financial reporting risks for a financial reporting element, it is unlikely management will identify only this type of entity-level control as adequately addressing a financial reporting risk. Further, the guidance clarifies that some entity-level controls may be designed to identify possible breakdowns in lower-level controls, but not in a manner that would, by themselves, adequately address financial reporting risks. In these cases, management would identify the additional controls needed to adequately address financial reporting risks, which may include those that operate at the transaction or account balance level. Consistent with the proposal, management does not need to identify or evaluate additional controls relating to a financial reporting risk if it determines that the risk is being adequately addressed by an entity-level control.

We have also revised the proposed guidance to further clarify that the controls management identifies in Section II.A.1 should include the entity-level and pervasive elements of its ICFR that are necessary to have a system of internal control that provides reasonable assurance as to the reliability of financial reporting. Management can use the

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<sup>89</sup> See, for example, letters from ACCA, ACE, Eli Lilly, European Association of Listed Companies (EALIC), and PwC.

existing control frameworks and related guidance to assist them in evaluating the adequacy of these aspects of their ICFR.

#### Information Technology General Controls

Commenters expressed concern that the proposal's guidance on IT general controls was too vague or that it lacked sufficient clarity<sup>90</sup> and requested further guidance and illustrative examples<sup>91</sup> to clarify the extent to which IT general controls are within the scope of the ICFR evaluation.<sup>92</sup> Commenters also suggested that the Commission directly incorporate the May 16, 2005 Staff Guidance<sup>93</sup> on IT general controls<sup>94</sup> and that we clarify that IT general controls alone, without consideration of application controls, will not sufficiently address the risk of material misstatement.<sup>95</sup> One commenter noted that providing such guidance could have the unintended consequence of setting a precedent for providing more detailed guidance in other areas of the evaluation.<sup>96</sup>

Commenters also suggested that we revise the proposal to clarify how a top-down approach considers IT general controls,<sup>97</sup> that we encourage a "benchmarking" approach for evaluating automated controls,<sup>98</sup> and that we permit companies who implement IT

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<sup>90</sup> See, for example, letters from Aerospace Industries Association, MasterCard, and Nasdaq.

<sup>91</sup> See, for example, letter from Microsoft Corporation (MSFT).

<sup>92</sup> See, for example, letters from Faisal Danka, ISACA, MSFT, Rod Scott, and The Travelers Companies, Inc. (Travelers).

<sup>93</sup> Division of Corporation Finance and Office of the Chief Accountant: Staff Statement on Management's Report on Internal Control Financial Reporting (May 16, 2005), available at <http://www.sec.gov/spotlight/soxcom/.htm>.

<sup>94</sup> See, for example, letters from FEI CCR and P&G.

<sup>95</sup> See, for example, letter from IDW.

<sup>96</sup> See, for example, letter from ICAEW.

<sup>97</sup> See, for example, letters from Cardinal and ISACA.

<sup>98</sup> See, for example, letter from CSC.



systems late in the year to do so while still being able to satisfy their ICFR responsibilities.<sup>99</sup>

We made several revisions to the proposed guidance based on the comment letters. We revised the proposal to explain that the identification of risks and controls within IT should be integral to, and not separate from, management's top-down, risk-based approach to evaluating ICFR and in determining the necessary supporting evidential matter. We clarified that controls which address financial reporting risks may be automated, dependent upon IT functionality, or require a combination of both manual and automated procedures and that IT general controls alone, without consideration of application controls, ordinarily do not adequately address financial reporting risks. We also incorporated guidance from the May 16, 2005 Staff Statement which explains that it is unnecessary to evaluate IT general controls that primarily pertain to efficiency or effectiveness of operations, but which are not relevant to addressing financial reporting risks.

We have declined to further specify categories or areas of IT general controls that will be relevant to the ICFR evaluation for all companies. We continue to believe that such determinations require consideration of each company's individual facts and circumstances. Moreover, we have concluded it is not necessary to include a discussion of a "benchmarking" approach to evaluating automated controls. The lack of such discussion in our guidance does not preclude management from taking such an approach if they believe it to be both efficient and effective.

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<sup>99</sup> See, for example, letter from Chamber.

Additionally, we did not revise the proposed guidance to discuss implementation of IT systems, or changes thereto, late in the year because we do not believe such decisions should be impacted by the requirement to evaluate and assess the effectiveness of ICFR. Even without the evaluation and assessment requirements, the implementation of an IT system late in the year does not change management's responsibility to maintain a system of internal control that provides reasonable assurance regarding the reliability of financial reporting. Allowing an exclusion from the evaluation for controls placed in operation late in the year could have the unintended consequence of negatively impacting the reliability of financial reporting. Management has the ability to mitigate the risk of material misstatement that arises from ineffective controls in a new IT system. For example, management may perform pre-implementation testing of the IT controls needed to adequately address financial reporting risks. Additionally, management may implement compensating controls, such as manual reconciliations and verification, until such time that management has concluded that the IT controls within the system are adequate. Accordingly, we do not believe it is necessary or appropriate to exclude new IT systems or changes to existing systems from the scope of the evaluation of ICFR.

## **E. Evaluating Evidence of the Operating Effectiveness of ICFR**

### **1. Summary of the Proposal**

Our proposal indicated that management should consider both the risk characteristics of the financial reporting elements to which the controls relate and the risk characteristics of the controls themselves (collectively, ICFR risk) in making judgments about the nature and extent of evidence necessary to provide a reasonable basis for the assessment of whether the operation of controls is effective. The proposal identified

significant accounting estimates, related party transactions and critical accounting policies as examples of financial reporting areas that generally would be assessed as having a higher risk of misstatement and control failure. However, the proposed guidance recognizes that since not all controls have the same risk characteristics, when a combination of controls is required to adequately address the risks to a financial reporting element, management should analyze the risk characteristics of each control separately. Further, under the proposed guidance, when evaluating risks in multi-location environments, management should generally consider the risk characteristics of the controls related to each financial reporting element, rather than making a single judgment for all controls at a particular location when determining the sufficiency of evidence to support its assessment.

Our proposal indicated that the evidence of the operation of controls that management evaluates may come from a combination of on-going monitoring and direct testing and that management should vary the nature, timing and extent of these based on its assessment of the ICFR risk. Our proposal stated that this evidence would ordinarily cover a reasonable period of time during the year and include the fiscal year-end. The proposal also acknowledged that, in smaller companies, those responsible for assessing the effectiveness of ICFR may, through their on-going direct knowledge and supervision of the operation of controls (that is, daily interaction) have a reasonable basis to evaluate the effectiveness of some controls without performing direct tests specifically for purposes of the evaluation.

The proposal explained that the evidential matter constituting reasonable support for the assessment would generally include the basis for management's assessment and

documentation of the evaluation methods and procedures for gathering and evaluating evidence. Additionally, the proposal indicated that the nature of the supporting evidential matter, including documentation, may take many forms and may vary based on management's assessment of ICFR risk. For example, management may determine that it is not necessary to maintain separate copies of the evidence evaluated if such evidence already exists in the company's books and records. The proposal also indicates that as the degree of complexity of the control, the level of judgment required to operate the control, and the risk of misstatement in the financial reporting element increase, management may determine that separate evidential matter supporting a control's operation should be maintained.

## **2. Comments on the Proposal and Revisions Made**

The Commission received a number of comments on the proposed guidance for evaluating whether the operation of controls was effective. As discussed in Section III.B above, many of these commenters requested more examples or more detailed guidance. Other comments received related to the appropriateness of various "rotational" approaches to evaluating evidence of whether the operation of controls was effective; the nature of on-going monitoring activities, including self-assessments and daily interaction; the time period to be covered by evaluation procedures; and supporting evidential matter.

### Rotational Approaches to Evaluating Evidence

Commenters requested that the guidance explicitly allow management to rotate its evaluation of evidence of the operation of controls and a variety of different approaches for doing so were suggested. These approaches included, for example, a rotational

approach for lower risk controls,<sup>100</sup> a rotational approach in areas where management determines there are no changes in the controls since the previous assessment,<sup>101</sup> or a rotational approach where there is both lower risk and no changes in controls.<sup>102</sup> In addition, some suggested a “benchmarking” approach, similar to that used for IT controls, be allowed for non-IT controls.<sup>103</sup> Other commenters agreed with the proposal’s requirement that management consider evidence of the operation of controls each year.<sup>104</sup> Others noted that while they believed it is appropriate for management to consider the results of its prior year assessments, the guidance should make it clear that the evaluation of operating effectiveness is an annual requirement.<sup>105</sup>

Other commenters raised the issue of a rotational approach specific to multi-location considerations. For example, commenters suggested that the guidance allow for rotation of locations based upon risk (for example, once every three years).<sup>106</sup> However, some commenters suggested that the risk-based approach provided in the proposed guidance would appropriately allow companies to vary testing in locations based more on risk than coverage, which would improve the efficiency of their assessment.<sup>107</sup>

After considering the comments, the Commission has retained the guidance substantially as proposed. We did not introduce a concept that allows management to

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<sup>100</sup> See, for example, letters from CSC, EALIC, ING, MasterCard, and NYC Bar.

<sup>101</sup> See, for example, letters from P&G and Travelers.

<sup>102</sup> See, for example, letters from EEI and Supervalu.

<sup>103</sup> See, for example, letters from Eli Lilly and FEI CCR.

<sup>104</sup> See, for example, letters from CCMR, Deloitte, and KPMG.

<sup>105</sup> See, for example, letters from AFL-CIO, Center, CFA, Deloitte, and PwC.

<sup>106</sup> See, for example, letter from CSC.

<sup>107</sup> See, for example, letters from MSFT, New York State Society of Certified Public Accountants, and Plains Exploration & Production Company.

eliminate from its annual evaluation those controls that are necessary to adequately address financial reporting risks. For example, management cannot decide to include controls for a particular location or process within the scope of its evaluation only once every three years or exclude controls from the scope of its evaluation based on prior year evaluation results. To have a reasonable basis for its assessment of the effectiveness of ICFR, management must have sufficient evidence supporting the operating effectiveness of all aspects of its ICFR as of the date of its assessment. The guidance provides a framework to assist management in making judgments regarding the nature, timing and extent of evidence needed to support its assessment. Management can use this framework to scale its evaluation methods and procedures in response to the risks associated with both the financial reporting elements and related controls in its particular facts and circumstances.

However, the guidance has been clarified to reflect that management's experience with a control's operation both during the year and as part of its prior year assessment(s) may influence its decisions regarding the risk that controls will fail to operate as designed. This, in turn, may have a corresponding impact on the evidence needed to support management's conclusion that controls operated effectively as of the date of management's assessment.

#### Nature of On-Going Monitoring Activities

Commenters expressed concern that, as defined in the proposal, some on-going monitoring activities would not be deemed to provide sufficient evidence.<sup>108</sup> Other commenters were concerned that the guidance placed too much emphasis on the amount

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<sup>108</sup> See, for example, letters from BASF and Cees Klumper & Matthew Shepherd (C. Klumper & M. Shepherd).

of evidence that could be obtained from on-going monitoring activities and called for further examples of when they may provide sufficient evidence and when direct testing would be required.<sup>109</sup> With regard to self-assessments, commenters suggested that self-assessments can be an integral source of evidence when their effective operation is verified by direct testing over varying periods of time based on the manner in which the self-assessments were conducted and on the level of risk associated with the controls.<sup>110</sup> Other commenters requested the proposed guidance be revised to clarify how, based on the definitions provided, self-assessments differed from direct testing.<sup>111</sup>

Some commenters questioned the sufficiency of evidence that would result from management's daily interaction with controls and requested more specifics on when it would be appropriate as a source of evidence<sup>112</sup> and how management should demonstrate that its daily interaction with controls provided it with sufficient evidence to have a reasonable basis to assess whether the operation of controls was effective.<sup>113</sup>

Based on the feedback received, we modified the discussion of on-going monitoring activities, including self-assessments, and direct testing to clarify how the evidence obtained from each of the activities can vary. As commenters in this area noted, on-going monitoring, including self-assessments, encompasses a wide array of activities that can be performed by a variety of individuals within an organization. These individuals have varying degrees of objectivity, ranging from internal auditors to the personnel involved in business processes, and can include both those responsible for

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<sup>109</sup> See, for example, letters from Center and EY.

<sup>110</sup> See, for example, letters from GT and C. Klumper & M. Shepherd.

<sup>111</sup> See, for example, letter from Cardinal.

<sup>112</sup> See, for example, letters from BDO, EY, Ohio, and Tatum.

<sup>113</sup> See, for example, letter from Ohio.

executing a control as well as those responsible for overseeing its effective operation. Because of the varying degrees of objectivity, the sufficiency of the evidence management obtains from on-going monitoring activities is determined by the nature of the activities (that is, what they entail and how they are performed).

We clarified the proposed guidance to indicate that when evaluating the objectivity of personnel, management is not required to make an absolute conclusion regarding objectivity, but rather should recognize that personnel will have varying degrees of objectivity based on, among other things, their job function, their relationship to the control being evaluated, and their level of authority and responsibility within the organization. Management should consider the ICFR risk of the controls when determining whether the objectivity of the personnel involved in the monitoring activities results in sufficient evidence. For example, for areas of high ICFR risk, management's on-going monitoring activities may provide sufficient evidence when the monitoring activities are carried out by individuals with a high degree of objectivity. However, when management's support includes evidence obtained from activities performed by individuals who are not highly objective, management would ordinarily supplement the evidence with some degree of direct testing by individuals who are independent from the operation of the control to corroborate the information from the monitoring activity.

With regard to requests for more guidance related to management's daily interaction, we have adopted the guidance substantially as proposed. We believe that in smaller companies, management's daily interaction with the operation of controls may provide it with sufficient evidence to assess whether controls are operating effectively. The guidance is not intended to limit management's flexibility with regard to the areas of



ICFR where its interaction can provide it with sufficient evidence or the manner by which management obtains knowledge of the operation of the controls. However, as noted in the guidance, daily interaction as a source of evidence for the operation of controls applies to management who are responsible for assessing the effectiveness of ICFR and whose knowledge about the effective operation is gained from its on-going direct knowledge and direct supervision of controls. In addition, the evidence management maintains in support of its assessment should include the design of the controls that adequately address the financial reporting risks as well as how its interaction provides an adequate basis for its assessment of the effectiveness of ICFR.

#### Time Period Covered by Evaluation Procedures

Commenters requested that the guidance allow for, and encourage, management to gather evidence throughout the year to support its assessment in lieu of having to gather some evidence close to or as-of year-end.<sup>114</sup> These commenters believed that such guidance would encourage companies to better integrate their evaluation procedures into the normal activities of their daily operations, spread the effort more evenly throughout the year, and help reduce the strain on resources at year-end when company personnel are preparing the annual financial statements and complying with other financial reporting activities.

We agree with the comments received in this area with respect to allowing management the flexibility to gather evidence in support of its assessment during the year. Since management's assessment is performed as of the end of its fiscal year-end, the evidence management utilizes to support its assessment would ordinarily include a

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<sup>114</sup> See, for example, letters from Eli Lilly, The Financial Services Roundtable, and Neenah Paper, Inc.

reasonable period of time during the year, including some evidence as of the date of its assessment. However, the proposal was not intended to limit management's flexibility to conduct its evaluation activities during the year. Rather, the proposed guidance was intended to provide management with the ability to perform a variety of activities covering periods of time that vary based on its assessment of risk in order to provide it with a sufficient basis for its evaluation. This could include, for example, a strategy that employs direct testing over a control during the year (but prior to year-end), that is supplemented with a self-assessment activity at year-end. As a result, we have adopted the guidance related to the period of time for which management should obtain evidence of the operation of controls substantially as proposed.

#### Supporting Evidential Matter

Commenters expressed support for the guidance in the proposal related to the supporting evidential matter and believed it would allow management to make better judgments and allow for sufficient flexibility to vary the nature and extent of evidence based on the company's particular facts and circumstances.<sup>115</sup> Other commenters observed that a certain level of documentation was required in order to facilitate an efficient and effective audit and suggested the guidance explicitly state this fact and/or clarify how the guidance for management was intended to interact with the requirements provided to auditors.<sup>116</sup> One commenter requested that we clarify our intention related to

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<sup>115</sup> See, for example, letters from BR, EY, Hudson Financial Solutions (HFS), and MSFT.

<sup>116</sup> See, for example, letters from Center, Deloitte, EY, GT, M&P, MetLife, MDFC, PwC, and N. Stofberg.

the audit committee's involvement in the review of evidential matter prepared by management in support of its assessment.<sup>117</sup>

After consideration of the comments, we are adopting the guidance substantially as proposed. We continue to believe that management should have considerable flexibility as to the nature and extent of the documentation it maintains to support its assessment, while at the same time maintaining sufficient evidence to provide reasonable support for its assessment. Providing specific guidelines and detailed examples of various types of documentation would potentially limit the flexibility we intended to afford management.

With respect to the concerns raised regarding the interaction of the proposed guidance and the audit requirements, we determined that no changes were necessary. Similar to an audit of the financial statements, the nature and extent of evidential matter maintained by management may impact how an auditor conducts the audit and the efficiency of the audit. We believe that the most efficient implementation by management and the auditor is achieved when flexibility exists to determine the appropriate manner by which to complete their respective tasks. However, we also believe that the Proposed Auditing Standard allows auditors sufficient flexibility to consider various types of evidence utilized by management. The audit standard allows auditors to adjust their approach in certain circumstances, if necessary, so that audit procedures should not place any undue burden or expense on management's evaluation process.

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<sup>117</sup> See, for example, letter from ABA.

## **F. Evaluation of Control Deficiencies**

### **1. Summary of the Proposal**

The proposal directed management to evaluate each control deficiency that comes to its attention in order to determine whether the deficiency, or combination of control deficiencies, is a material weakness. The proposal defined 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 by the company's ICFR. The proposal contained guidance on the aggregation of deficiencies by indicating that multiple control deficiencies that affect the same financial reporting element increase the likelihood of misstatement and may, in combination, constitute a material weakness, even though such deficiencies may be individually insignificant. The proposal also highlighted four circumstances that were strong indicators that a material weakness in ICFR existed. In summary, the following four items were listed:

- An ineffective control environment, including identification of fraud of any magnitude on the part of senior management; significant deficiencies that remain unaddressed after some reasonable period of time; and ineffective oversight by the audit committee (or entire board of directors if no audit committee exists).
- Restatement of previously issued financial statements to reflect the correction of a material misstatement.

- Identification by the auditor of a material misstatement of financial statements in the current period under circumstances that indicate the misstatement would not have been discovered by the company's ICFR.
- For complex entities in highly regulated industries, an ineffective regulatory compliance function.

## **2. Comments on the Proposal and Revisions Made**

### Definition of Material Weakness

Commenters expressed concern about differences between our proposed definition of material weakness and that proposed by the PCAOB in its Proposed Auditing Standard and requested that the two definitions be aligned.<sup>118</sup> Commenters provided feedback on the reasonably possible threshold for determining the likelihood of a potential material misstatement as well as the reference to interim financial statements for determining whether a potential misstatement could be material. Commenters also suggested that a single definition of material weakness be established for use by both auditors and management and that definition be established by the SEC in its rules.<sup>119</sup> Based on comments on the proposal, we are amending Exchange Act Rule 12b-2 and Rule 1-02 of Regulation S-X to define the term material weakness. Further discussion and analysis of the definition of material weakness and commenter feedback can be found in that rule release.<sup>120</sup>

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<sup>118</sup> See, for example, letters from EEI, FEI CCR, FEI SPCTF, ICAEW, N. Stofberg, and SVLG.

<sup>119</sup> See, for example, letters from FEE and ICAEW.

<sup>120</sup> Release No. 34-55928.

### Strong Indicators of a Material Weakness

Commenters noted there were differences in the list of strong indicators included in the proposal and the list of strong indicators included in the Proposed Auditing Standard, raising concern that the failure of the two proposals to provide similar guidance would cause unnecessary confusion between management and auditors.<sup>121</sup> Commenters also provided suggested changes, additions or deletions to circumstances that were included on the list of strong indicators. For example, commenters raised questions about the “identification of fraud of any magnitude on the part of senior management,” questioning the appropriateness of the term “of any magnitude” or which individuals were encompassed in the term “senior management.”<sup>122</sup> Commenters also felt the Commission’s proposed list of indicators should be expanded to include the indicator relating to an ineffective internal audit function or risk assessment function that was included in the Proposed Auditing Standard.<sup>123</sup> One commenter felt that the list of strong indicators needed to be made more specific, and should include more illustrative examples.<sup>124</sup> Another commenter stated that the indicator of “significant deficiencies that have been identified and remain unaddressed after some reasonable period of time” should be clarified to mean unremediated deficiencies.<sup>125</sup> Other commenters suggested that the list of strong indicators be eliminated completely, stating that designating these items as strong indicators creates a presumption that such items are, in fact, material

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<sup>121</sup> See, for example, letters from BDO, BR, Center, Cleary, CSC, Deloitte, KPMG, M&P, and Schneider Downs & Co., Inc. (Schneider).

<sup>122</sup> See, for example, letters from 100 Group, Eli Lilly, FEI CCR, and P&G.

<sup>123</sup> See, for example, letters from BR, Crowe Chizek & Company LLC (Crowe), Deloitte, and M&P.

<sup>124</sup> See, for example, letter from Chamber.

<sup>125</sup> See, for example, letter from EEI.

weaknesses, and may impede the use of judgment to properly evaluate the identified control deficiency in light of the individual facts and circumstances.<sup>126</sup> Commenters also felt the Commission should clearly indicate that a company may determine that no deficiency exists despite the fact that one of the identified strong indicators was present.<sup>127</sup>

After consideration of the comments, we have decided to modify the proposed guidance. We believe judgment is imperative in determining whether a deficiency is a material weakness and that the guidance should encourage management to use that judgment. As a result, we have modified the guidance to emphasize that the evaluation of control deficiencies requires the consideration of all of the relevant facts and circumstances. We agreed with the concerns that an overly detailed list may create a list of de facto material weaknesses or inappropriately suggest that identified control deficiencies not included in the list are of lesser importance. At the same time, however, we continue to believe that highlighting certain circumstances that are indicative of a material weakness provides practical information for management. As a result, rather than referring to “strong indicators,” the final guidance refers simply to “indicators.” This change should further emphasize that the presence of one of the indicators does not mandate a conclusion that a material weakness exists. Rather management should apply professional judgment in this area. These examples include indicators related to the results of the financial statement audit, such as material audit adjustments and restatements, and indicators related to the overall evaluation of the company’s oversight of financial reporting, such as the effectiveness of the audit committee and incidences of

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<sup>126</sup> See, for example, letters from Cleary, Institute of Internal Auditors (IIA), and NYC Bar.

<sup>127</sup> See, for example, letters from Chamber, Cleary, CSC, PPL, and Schneider.

fraud among senior management. These examples are by no means an exhaustive list. For example, under COSO, risk assessment and monitoring are two of the five components of an effective system of internal control. If management concludes that an internal control component is not effective, or if required entity-level or pervasive elements of ICFR are not effective, it is likely that internal control is not effective.

Lastly, we agreed with commenters that it is appropriate for the Commission's guidance in this area to mirror the PCAOB's auditing standard. As a result, we have worked with the PCAOB in reaching conclusions regarding the guidance in this area, and we anticipate the PCAOB's auditing standard will align with our final management guidance.

#### **G. Management Reporting and Disclosure**

Comment letters expressed various viewpoints regarding the information management provides as part of its report on the effectiveness of ICFR. For example, commenters raised concerns regarding the "point in time" assessment and suggested various alternative approaches.<sup>128</sup> Commenters also made suggestions regarding the disclosures management provides when a material weakness has occurred. Certain commenters felt the suggested disclosures indicated in the proposing release should be mandatory,<sup>129</sup> while other commenters wanted the Commission to specify where in the Form 10-K management must provide its disclosures.<sup>130</sup> Commenters also requested that

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<sup>128</sup> See, for example, letters from BHP Billiton Limited, Eli Lilly, and IIA.

<sup>129</sup> See, for example, letters from HFS, IDW, and Tatum.

<sup>130</sup> See, for example, letters from Crowe and KPMG.



the Commission include in its release additional possible disclosures for consideration by management to include in its report.<sup>131</sup>

In addition, commenters expressed concerns regarding the language in the Proposing Release with respect to management's ability to determine that ICFR is ineffective due solely to, and only to the extent of, the identified material weakness(es). Some commenters felt that this language was essentially the same as a qualified opinion, which is prohibited by the guidance,<sup>132</sup> while two others stated that the Commission needed to provide additional guidance around the circumstances under which this approach would be appropriate.<sup>133</sup>

Based on the feedback we received, we have eliminated this from the final interpretive guidance and revised the proposed guidance to simply state that management may not state that the company's ICFR is effective. However, management may state that controls are ineffective for specific reasons.

Additionally, certain of the requests received seemed inconsistent with the statutory obligation. For example, Section 404(a)(2) of Sarbanes-Oxley requires that management perform the assessment as of the end of its most recent fiscal year. As a result, we do not believe any further changes to the proposed guidance around management's expression of its assessment of the effectiveness of ICFR are necessary.

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<sup>131</sup> See, for example, letters from PCG Worldwide Limited and PepsiCo, Inc. (Pepsi).

<sup>132</sup> See, for example, letters from BDO and CFA.

<sup>133</sup> See, for example, letters from Crowe and Deloitte.

## **H. Previous Staff Guidance and Staff Frequently Asked Questions**

Commenters raised questions regarding the status of guidance previously issued by the Commission and its staff, on May 16, 2005,<sup>134</sup> as well as the Frequently Asked Questions (“FAQs”).<sup>135</sup> Some commenters requested the FAQs be retained in their entirety,<sup>136</sup> while others requested that some particular FAQs be retained.<sup>137</sup> As we indicated in the proposed guidance, the May 2005 guidance remains relevant.

Additionally, we have instructed the staff to review the FAQs and, as a result of the final issuance of this guidance, update them as appropriate.

## **I. Foreign Private Issuers**

The Commission received comments directed towards the information included in the proposed guidance related to foreign private issuers. While three commenters noted that no additional guidance for foreign private issuers was necessary,<sup>138</sup> other commenters suggested changes. Commenters raised concerns regarding potential duplicative efforts and costs foreign registrants are subject to, as a result of similar regulations in their local jurisdictions.<sup>139</sup> These commenters requested that the Commission attempt to minimize or remove any duplicative requirements, with some

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<sup>134</sup> Commission Statement on Implementation of Internal Control Reporting Requirements, Press Release No. 2005-74 (May 16, 2005); Division of Corporation Finance and Office of the Chief Accountant: Staff Statement on Management’s Report on Internal Control Financial Reporting (May 16, 2005), available at <http://www.sec.gov/spotlight/soxcom/.htm>.

<sup>135</sup> Office of the Chief Accountant and Division of Corporation Finance: Management’s Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports Frequently Asked Questions (revised Oct. 6, 2004), available at <http://www.sec.gov/info/accountants/controlfaq1004.htm>.

<sup>136</sup> See, for example, letters from BP p.l.c. (BP), GT, IIA, ISACA, MSFT, and Tatum.

<sup>137</sup> See, for example, letters from BDO, EY, KPMG, and Stantec Inc.

<sup>138</sup> See, for example, letters from BP, Manulife, and Pepsi.

<sup>139</sup> See, for example, letters from 100 Group, Banco Itaú Holding Financeira SA, CCMR, Eric Fandrich, and FEI CCR.

requesting the Commission exempt foreign registrants entirely from the ICFR reporting requirements if the registrant was subject to similar regulations in their home country. Other commenters raised concerns relating to the unique challenges that foreign registrants face in evaluating their ICFR, including language and cultural differences and international legal differences.<sup>140</sup>

Commenters also made suggestions regarding how the reconciliation to U.S. GAAP should be handled in the evaluation of ICFR. Certain commenters expressed support for the Commission's position that foreign private issuers should scope their evaluation effort based on the financial statements prepared in accordance with home country GAAP, rather than based on the reconciliation to U.S. GAAP.<sup>141</sup> However, other commenters requested that the Commission exempt the reconciliation to U.S. GAAP from the scope of the evaluation altogether,<sup>142</sup> while others sought further clarification as to whether and how the reconciliation was included in the evaluation of ICFR,<sup>143</sup> with one commenter suggesting the Commission staff publish additional Frequently Asked Questions to address any implementation issues.<sup>144</sup> One commenter requested the Commission exclude from the evaluation process those financial statement disclosures that are required by home country GAAP but not under U.S. GAAP to minimize the differences in the ICFR evaluation efforts between U.S. registrants and foreign filers as much as possible.<sup>145</sup>

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<sup>140</sup> See, for example, letters from IIA and GT.

<sup>141</sup> See, for example, letters from 100 Group, BDO, and ICAEW.

<sup>142</sup> See, for example, letters from CCMR, Cleary, EALIC, and NYC Bar.

<sup>143</sup> See, for example, letters from Deloitte, EY, KPMG, and N. Stofberg.

<sup>144</sup> See, for example, letter from Ohio.

<sup>145</sup> See, for example, letter from ING.

After considering the comments received, the Commission has determined not to exempt foreign registrants from the ICFR reporting requirements, regardless of whether they are subject to similar home country requirements. The Commission's requirement for all issuers to complete an evaluation of ICFR is not derived from the Commission's Interpretive Guidance for Management; this requirement has been established by Congress. Further, the Commission does not believe it is appropriate to exclude the U.S. GAAP reconciliation from the scope of the evaluation as long as it is a required element of the financial statements. Currently, however, the Commission is evaluating, as part of another project, the acceptance of International Financial Reporting Standards ("IFRS") as published by the International Accounting Standards Board ("IASB") without reconciliation to U.S. GAAP.<sup>146</sup>

In light of the comment letters, the Commission realizes that there are certain implementation concerns and issues that are unique to foreign private issuers. As a result, the Commission has instructed the staff to consider whether these items should be addressed in a Frequently Asked Questions document.

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<sup>146</sup> In a press release on April 24, 2007, the Commission announced its next steps pertaining to acceptance of IFRS without reconciliation to U.S. GAAP. In that press release, the Commission stated that it anticipates issuing a Proposing Release in summer 2007 that will request comments on proposed changes to the Commission's rules which would allow the use of IFRS, as published by the IASB, without reconciliation to U.S. GAAP in financial reports filed by foreign private issuers that are registered with the Commission. The press release is available at <http://www.sec.gov/news/press/2007/2007-72.htm>.

**List of Subjects**

17 CFR Part 241

Securities.

**TEXT OF AMENDMENTS**

For the reasons set out in the preamble, the Commission is amending Title 17, chapter II, of the Code of Federal Regulations as follows:

**PART 241 – INTERPRETATIVE RELEASES RELATING TO THE SECURITIES  
EXCHANGE ACT OF 1934 AND GENERAL RULES AND REGULATIONS  
THEREUNDER**

Part 241 is amended by adding Release No. 34-55929 and the release date of June 20, 2007 to the list of interpretative releases.

By the Commission.

Nancy M. Morris  
Secretary

Dated: June 20, 2007