SOX 404: SEC's Interpretive Guidance for Management

Webcast Presentation

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About Trent Gazzaway

Trent is an audit partner and the partner-in-charge of corporate governance for Grant Thornton LLP. Trent's experience includes auditing public and private companies and assisting an array of companies in the improvement and documentation of effective systems of internal control. He has also assisted large public companies in the development and execution of plans to restate their financial statements in the wake of internal control failures.

In addition to managing the Firm's corporate governance practice, Trent serves as a key resource in training Grant Thornton personnel to audit internal controls over financial reporting in accordance with newly established auditing standards. He is one of four steering committee chairmen assisting in the development of the Open Compliance and Ethics Group's framework for integrating governance, compliance, risk management and integrity into all business processes (www.oceg.org). Trent is also a member of the advisory board of the Enterprise Risk Management Initiative (www.mgt.ncsu.edu/erm) at NC State University's College of Management.

Most recently, Trent was appointed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) board to lead a project to develop guidance regarding the effective monitoring of internal control in accordance with COSO's Internal Control—Integrated Framework.

Trent is a frequent speaker at seminars, has authored several nationally and internationally published articles related to Sarbanes-Oxley and corporate governance, and publishes Grant Thornton's award-winning quarterly CorporateGovernor newsletter.

Education

Trent has a Bachelor of Science in Business Administration and a Masters of Accounting from the University of North Carolina at Chapel Hill.

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New and Improved SOX 404 Part 1: SEC's Interpretive Guidance for Management

Overview:

– SEC's Interpretive Guidance for Management
– COSO Guidance on Monitoring Internal Control

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Today I want to talk about two things in particular. One is the SEC's interpretive guidance for management. It was released in May, but there is still a lot of discussion going on about what it means and how companies can use it. And then, of course, COSO's most recently issued discussion document on monitoring and internal control. These two documents are two legs of what I call a three-legged stool for improvement in the 404 process.

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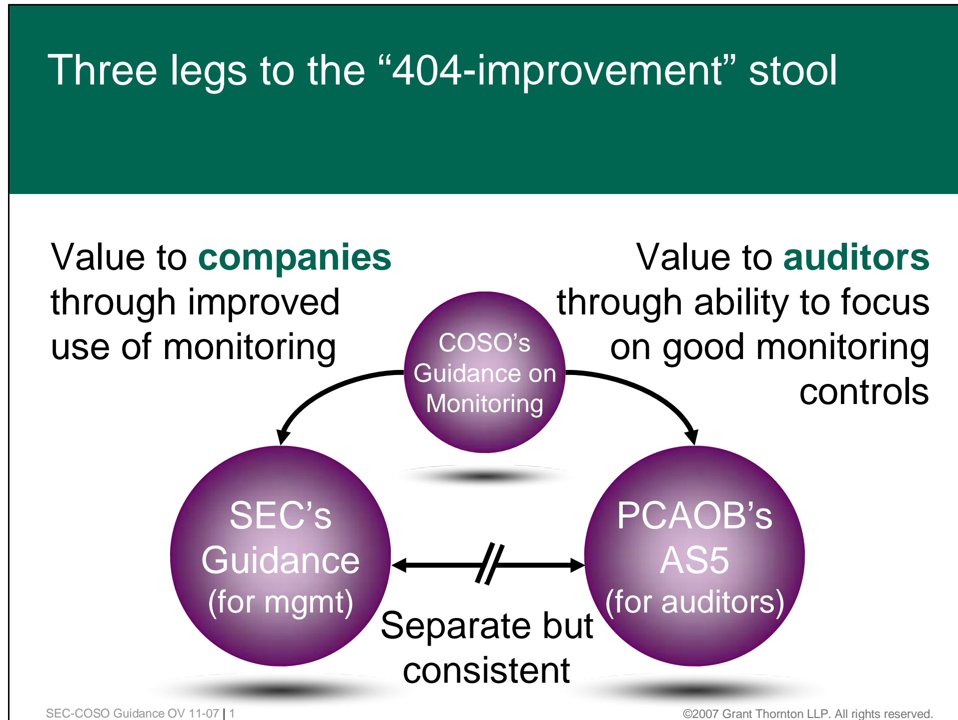
Three Legs to the "404" Improvement Stool



At the bottom of the slide are two bubbles: one that talks about the SEC's guidance for management and the other that talks about the PCAOB's AS-5 for auditors.

In 2007, the SEC and PCAOB split the guidance for both auditors and management regarding the evaluation of internal control over financial reporting. This separation was precipitated by a realization that the way management evaluates internal controls is different, in some respects, than the way auditors evaluate internal controls, if for no other reason than because management is much closer to the operation of the controls. In many cases, management helps design the controls, and lives with them day to day, as opposed to the independent auditor, who cannot have as much implicit knowledge about control design or operation.

In the process, the PCAOB re-wrote AS-2 in the form of AS-5 to make the auditor's approach less prescriptive. AS-5 allows and encourages auditors to use more judgment than they felt like they could employ in the past. And it also encourages more use of the work of others.

I'm not going to talk much more about AS-5. I want to focus on what the SEC and COSO guidance can help you accomplish, namely (1) to focus your internal control evaluation efforts on areas of meaningful risk to your financial statements without adding unnecessary redundancy, and (2) to

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demonstrate how your effective monitoring of internal control can affect the efficiency of the external auditor's work.

The driving factor for producing all of this guidance is really to improve the efficiency of the overall process. I don't think anyone will argue the fact that the initial implementation of Section 404 was more costly than anyone had anticipated. One of the major reasons for that was a general lack of guidance for companies and auditors regarding what a good evaluation of internal control might look like.

I want to take a moment and differentiate between what the SEC's goal was in producing its guidance, and the PCAOB's goal in producing AS-5, versus what COSO's goal was in creating guidance on monitoring internal control. They are very closely aligned, but there are some slight differences.

The SEC and the PCAOB were focused primarily on the year-end, point-in-time management assertion and related audit opinion. What do you have to do to get comfortable *as of the end of the fiscal year* that you have good internal control? What does the auditor have to do to support the same conclusion? The reason for this point-in-time focus is, very simply, because Sarbanes-Oxley requires a point-in-time assertion that says whether or not, as of the end of the fiscal year, you have effective internal control.

That's a little bit different than the way companies actually look at internal control, and logically so. Management typically doesn't seek to be comfortable only on a specific date. It usually wants to have a good feeling across the whole year that the organization has good internal control. That doesn't mean that you're ready at any point in time to sign an assertion that says, as of this particular date, and every day during the year, I can tell the world that I have perfect internal control today. But what it does say is that management typically desires to have a reasonable basis for believing, really throughout the year, that it has good internal control.

So, if you have that reasonable basis throughout the year for believing that you have good internal control, then the effort that it takes to sign a point-in-time assertion at the end of the year shouldn't be dramatically different than what you do throughout the year -- if your monitoring of internal controls is effective.

So what the COSO monitoring guidance attempts to do -- and I'm going to talk about this in more detail later -- is highlight how you can bake effective monitoring into your day-to-day operations, and in fact, how it's already, in many cases, baked into day-to-day operations. It's about how you can take credit for that and use it to support your assertions about internal controls at the end of the year.

The overall goal of all of this – the SEC's guidance and COSO's guidance -- is to end this massive fourth-quarter exercise to sign off on internal controls

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for compliance purposes and get it back to what I personally believe Congress always intended: that management (1) have a reasonable basis for believing that it has good internal control, and (2) be in a position, at the end of the year, to tell investors that it does have good internal controls.

So, what we see in the COSO guidance, and I think what our personal goal is in helping to develop that guidance, is that companies will obtain value through the COSO guidance in helping to use their day-to-day monitoring activities to support their year-end assertions; and that auditors will gain some value out of it by learning what effective monitoring looks like, enabling them to focus more on management's monitoring of internal controls than on the detailed individual control testing that happens down deep in the operations of the company. I have an example that I'm going to go through in a few minutes that highlights what we're trying to accomplish here.

Now, I'm going to start with a discussion about the SEC's guidance. And what I should say is that, while I certainly don't purport to speak on behalf of the SEC, I have reviewed these slides with knowledgeable people at the SEC to make sure they don't have problems with the general message. As I go through this, I'll make sure that I clarify when I'm making points that are purely my interpretation, but certainly, don't take anything that I say as being the SEC's expressed interpretation.

I should also say that we've got only 30 minutes here to talk about this. That certainly can't substitute for reading both of these documents -- the SEC's interpretive guidance for management and COSO's discussion document on monitoring internal controls. My goal here is to highlight some of the key points in those documents, and give you something to hang onto when you open the documents yourself to read them. So let's talk about the SEC's guidance.

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SEC's New Interpretive Guidance for Management

SEC's new interpretive guidance for management

- interpretive guidance **proposed** in December 2006
  - comment period ended February 26, 2007
  - more than 200 comment letters received
- final interpretive guidance **approved** by Commission on May 23, 2007

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The SEC's interpretive guidance was proposed in December of '06. Back then, companies really didn't have a lot of choice but to look to AS-2 to find out what they should be doing to evaluate internal control. As I mentioned earlier, that's not the most effective way for companies to evaluate their own internal controls. So the SEC pulled that guidance out of AS-2 and created stand-alone guidance.

The comment period for the proposed guidance ended in February. In the end, the SEC received more than 200 comment letters, which is an extraordinary number of comment letters for something like this. It was an overwhelming response to the document. I think the response was very positive. The SEC received a lot of constructive comments, edited the document and issued final guidance that was approved by the Commission near the end of May of 2007.

Coincidentally, or really not coincidentally, the PCAOB finalized its Auditing Standard No. 5 (AS-5) around the same time, and both documents came out more or less simultaneously. They did work together on the documents. The SEC had people that were involved and listened to some of the discussions with the PCAOB and vice versa. They really sought to make the document consistent where it made sense to make it consistent. But where it didn't make sense for it to be consistent, then they naturally divided the two, which makes a lot of sense. I will tell you that I think, across the auditing profession, and as far as I can tell, within the financial reporting

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profession at large, the guidance has been well received. I think it is a positive step towards improving the efficiency of the evaluation of internal controls.

Key Attributes

SEC's guidance (cont'd)

Key attributes:

- principles-based
- directs efforts to highest risks of material misstatement
- allows evaluation to be tailored to facts and circumstances
- provides guidance on supporting evidence and documentation
- provides guidance for evaluating deficiencies
- does not replace control frameworks
- voluntary

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Let me talk about some key attributes within this guidance. I'll talk first about the bullets on the left-hand side of this slide as a group. I think the first thing that the SEC wanted to do, was to make sure that the guidance it produced was principles-based and risk-based. In other words, it had organizations focus on things that were most important. Yet it was never intended to be a prescriptive document that said this is absolutely the way you must do things. So it does not present for you a list of controls that you should test. It doesn't present a list of accounts that you should focus on. It tells you as a company that you should evaluate the effective operation of the design of those controls. And here's where I use some of my own terms. The way I interpret that is to say, as an organization, you need to be comfortable that a reasonable person would look at what is done and say, "Yeah, they had the right scope. They looked at the right areas. They understand the right risks. They looked at the controls that are most important to mitigating those key risks. And they documented it enough so that a reasonable person can look at it and say yes, there is enough here to support that assertion." So I look at it as kind of a "reasonable person" standard. Did we do enough here to get comfortable that we have effective internal control?

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The right-hand side gets into a little bit more detail about what the SEC has provided. It's provided some guidance on the supporting evidence -- in other words, the scope of work that you might need to consider when you are evaluating internal controls; the risk-based approach; some of the risk factors to consider. And it also talked about documentation. It didn't prescribe documentation. But it talked about the importance of documentation, and gave you some things to think about.

It also provided some guidance on evaluating deficiencies. There won't be any great surprises when you look at that part of the guidance -- you want to look at deficiencies based on their *significance* and their *likelihood* or "reasonable possibility" of causing material mistakes on the financial statements.

Several important points are that the SEC's guidance does not seek to replace the control frameworks -- the COSO framework, or the COCO framework in Canada, or the Turnbull guidance in the UK, or others. The goal was to provide a good framework for management to use in considering what it takes to support a point-in-time assertion. But the SEC actually encouraged within their management guidance -- and in fact, you'll see a quote later on in this presentation -- the further development of guidance on evaluating internal controls from bodies such as COSO or others. Of course, COSO has taken up the task.

The particular point I want to make on this slide, is that the application of the SEC's guidance is voluntary. It is interpretive guidance. It's not a rule. There are some companies out there that are doing more than what the interpretive guidance would suggest. Many of those companies don't want to change what they're doing. They've reached a status quo. They're comfortable with what they're doing. In which case, the SEC would say, "That's fine, continue to do what you're doing." There are some companies out there that may be doing less than what this interpretive guidance would suggest. The SEC would never call this guidance a safe harbor, by any stretch, and I'm not going to call it that here. But if you do less than what the SEC interpretive guidance suggests, then you will want to have reasonable logic for doing so if you ever get a question about it from the SEC. But it is important to note that the SEC's guidance is voluntary. It is not a requirement.

Having said that, I think it's very helpful guidance, and something that I think all organizations should at least take a look at and consider.

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Design and Operating Effectiveness of Controls

So let's look at what it says. The first thing that it says -- and here is a "should" that's in the guidance: "Management *should* evaluate the design and operating effectiveness of controls."

Now, it's not just the design effectiveness and it's not just the operating effectiveness. It's the design *and* operating effect of controls. And if you think about that, whether you are subject to Sarbanes-Oxley or not, you should, as an organization, be comfortable that you have the appropriate internal controls in place, and have a reasonable basis for concluding that they are operating effectively. So the SEC isn't suggesting anything more here than what the Foreign Corrupt Practices Act suggested back in 1977.

They talk a little bit more about some things that might be included in an evaluation of the design and operating effectiveness of controls, including identifying risks and related controls, evaluating their effectiveness, reporting the results, then maintaining supporting evidence and documentation. This is not prescriptive, but it does eliminate the notion that you can just wing it; that you can just sit back and say, well, we haven't had a problem in the past, and we've got good people, therefore, I think we probably have good internal controls.

You really can't evaluate the effectiveness of internal controls -- and this is me speaking, not the SEC -- unless you know what risks you face as an organization. Here, we're talking about internal control over financial

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reporting. So, as an organization, it seems logical to me that in order to say that you have effective internal control over financial reporting, you need to know what can go wrong related to financial reporting. Where is there a reasonable possibility that the financial statement could be materially misstated? It doesn't ask you to go beyond the level of reasonable possibility, although you may decide to do that. For efficiency reasons, you may want to dive down deeper than that. But certainly, you ought to know what risks present a reasonable possibility of having materially misstated financial statements. And then drill down and find the controls that you have in the organization that are supposed to mitigate that risk effectively and then evaluate how effectively those controls are designed and operated.

And, of course, you want to report the results to the right people in the organization and maintain some supporting evidence and documentation.

"Entity-level" Controls

SEC's guidance (cont'd)

Encourages a focus on "entity-level" controls:

- **indirect** — those that have an indirect effect on control system effectiveness (e.g., tone at the top)
- **monitoring** — those that monitor the effectiveness of other controls (see the COSO monitoring guidance)
- **precise** — those that operate at a level of precision that would adequately prevent or detect misstatements on a timely basis

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When they talk about a top-down, risk-based approach, both the SEC and the PCAOB encourage a focus on what they call "entity-level" controls. This term was coined long before the guidance was ever finalized. So long ago -- and again, this is me speaking here -- that I think that they were somewhat hemmed in by the term "entity-level controls," but I think they did a pretty good job of building on the term.

At a high level, you might envision entity-level controls as those that operate at the so-called home office, senior management or headquarters level of

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the organization. Now, if you think about controls that operate at that level, there is a reason they operate at that level. And one of those reasons is very possibly because those are the highest-risk areas. In other words, if senior–management is focused on certain controls, there is a good chance the reason they are focused on those controls is because they address meaningful risk to the organization. Therefore, from a risk-based perspective, it makes a lot of sense to start with these controls, because management has already determined that they are important enough to address at the entity level. So let's take a quick look at these three different categories.

The SEC talks first about entity-level controls that have an *indirect effect* on the internal control system and its effectiveness. And one of the primary examples for that is the overall control environment, including management's tone at the top. If you don't have an effective control environment and proper tone at the top then it's really difficult -- in fact, many would argue -- and I would argue -- that it's virtually impossible to have effective internal controls down in the organization. So the first thing to look at is, does the organization have appropriate tone at the top? Not just generically, but as it relates to some of the specific key risks. Is it clear that management has the appropriate focus? That they are putting the right people in place -- people with the appropriate skills and training -- to handle some of the complex areas, or some of the areas with the highest financial reporting risk? So that's the first stop. If you don't have that, then there is a pretty good chance that you are going to have weaknesses further down, and a greater need to focus on internal controls further down in the organization.

The second level of entity-level controls is those that monitor the effectiveness of other controls. And what I'd like you to think about there is what we're going to talk about when we get to the COSO guidance. That is, if management is effectively monitoring the effectiveness of other controls, then that monitoring can really be a key control in and of itself. I'll talk more about that when I get to my example.

But those controls that monitor the effectiveness of other controls, by their very nature, are designed along the lines of support for an assertion about internal controls. Because when you are monitoring controls, what you are saying is, is the key control here that I'm focused on -- is it designed and working right? Once you've concluded that an important control designed effectively, and that it's operating effectively, then from a SOX 404 perspective, or any assertion perspective, what else is required? That's exactly what SOX 404 was getting at: does management have a reasonable basis, at the entity level, for concluding that controls down in the organization are working the way that they are supposed to? At least, those that are important to the financial reporting process.

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The third level of what they call entity-level controls are those that operate with a level of precision that they themselves would prevent or detect a material error from getting to the financial statements. Now, it's a little bit harder to come up with a lot of examples for controls that operate at the entity level, but with that level of precision. But they do exist.

One example might be the following: Let's say that management knows what debt is outstanding and what interest rates apply to that debt. It can look on a quarterly basis and see the interest expense that the organization has charged and the average balance of the debt outstanding, do a rate calculation, and see that that rate is equivalent to the rate that's in effect. That may be enough to conclude that the controls before it are operating effectively. Maybe that's not the right way to phrase it. Maybe the right way to phrase it is to say that management's interest rate recalculation control, in and of itself, would prevent or detect a material error from getting into the financial statements. And therefore, that's the control that you ought to be focused on because it operates at a high-enough level of precision.

I will tell you that when we get into the COSO documentation, we actually want you to take that thought process down even further in the organization. Because one of the things that we've seen is that organizations sometimes will have ten controls in front of them, and they'll evaluate the effectiveness of all ten of those controls when one or two of those controls, further down the sequential line of controls, would actually, if operating effectively, identify an earlier control weakness before that control weakness can materially impact the financial statements.

So, an example that I might use is where you've got a three-way match between a purchase order, a receiving document, and the invoice. That three-way match can actually help catch a lot of errors that happen earlier in one of those three streams. If the three-way match is operating effectively, then it should or could influence the amount of work that you do to evaluate controls that happen earlier in those three streams. It may not eliminate testing, but it can certainly influence that testing, because that three-way match operates at that level of precision.

You have to be careful with that concept that you don't leave meaningful risks uncovered. But this concept of an entity-level control that operates with this level of precision, I think that you can actually take that even further down in the organization and improve the efficiency of your internal control evaluation.

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Documentation and Evidence

SEC's guidance (cont'd)

Discusses documentation and evidence:

- **documentation** of the design of identified controls is an integral part of management's reasonable support
- **type and extent** will vary based on the size, nature and complexity of the company
- **evidence** of operating effectiveness provided by ongoing monitoring or separate evaluation activities

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The SEC guidance then goes a little bit further and talks about documentation. It doesn't establish any requirements for documentation. It doesn't tell you exactly how to document. But it does suggest that you need to have documentation to support the effectiveness of your internal controls.

You need that for a couple of reasons. One is that it really helps you, as an organization, routinely evaluate the effectiveness of those internal controls on a consistent basis. But it also serves as evidence for outside parties, such as the SEC or the independent auditors, and can improve the efficiency of their review/audit process, if they can tag-team off of your documentation. But it's really just good business practice to have documentation for the major decisions that you've made about the effective design of the operational controls.

Design and operation of controls is certainly something that you want to be able to support. So the SEC encourages you to maintain some level of documentation that is commensurate with the size and complexity of your organization. The formality of that documentation is going to vary widely.

Now, the SEC also highlights -- and this is consistent with the COSO framework and several of the other frameworks out there -- the ways you might evaluate the effectiveness of controls: i.e., through a combination of ongoing monitoring and/or separate evaluation activities. Ongoing

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monitoring, which is really the direction that you want to try to lean towards, is monitoring that is really baked into the organization's routine activities. It's part of the normal operation. Separate evaluations are point-in-time evaluations that often have a separate risk-assessment process, or are often conducted by people that are separated from the actual process itself. The people that perform these separate evaluations are often more objective: they might be internal auditors or people from other areas of the organization. Management might also conduct some separate evaluations at levels deeper into the organization. But really, the goal is to incorporate as much as you possibly can into the ongoing monitoring activities, and really only employ the separate evaluations where you have to, where it's really necessary, from a risk perspective. There is a need to periodically re-confirm what you think is happening within the ongoing operations of the company. But you want to try to make those ongoing monitoring activities as effective as possible.

Now, as I talk about ongoing monitoring and separate evaluation activities, I'm really speaking more from the COSO monitoring guidance perspective than I am from the SEC's guidance. The SEC's guidance doesn't go into a lot of discussion about when to use ongoing monitoring versus separate evaluations. It was never the SEC's goal to articulate some bright line between the two. What it does say is that both ongoing monitoring and separate evaluation activities support your assertion of internal controls, and you ought to have some reasonable balance of those two different types of monitoring or evaluation procedures in place.

Framework for Evaluating Control Deficiencies

SEC's guidance (cont'd)

Includes …

- a framework for evaluating control deficiencies
- indicators of material weaknesses
- guidance regarding disclosures
  - same four required disclosures
  - SEC continues to see disclosures that do not adequately describe the nature and impact of identified deficiencies

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The SEC's guidance, as I mentioned earlier, includes a framework for evaluating control deficiencies. It suggests that you ought to look at both quantitative factors and qualitative factors. As I mentioned earlier, it suggests you should look at the probability that an error could occur, and the significance of that possible error. It is important to note -- and I see this a lot in practice -- that people think they've found an error, and that the individual error wasn't material. And so they say, "Well, since the individual error wasn't material, it can't possibly be a material weakness."

That's not really the evaluation criteria. That's part of the evaluation criteria. But it is very possible that you could have an error that, by itself, was not material, but it *could have been* material. So the real question is: is it reasonably possible that the nature of the error itself -- the root cause of the error -- could, at some point in the future, be material to the organization?

The SEC's guidance does include some indicators of material weakness. They used to be called, in old AS-2 language, "strong indicators" of material weakness. The SEC has changed it to just "indicators of material weakness," but it's the same general things that you would think of as being problematic: a re-statement of previously issued financial statements, the identification by the auditor of material adjustments to the financial statements that the company's internal control system did not catch or would not have caught, an audit committee that isn't conducting effective oversight, and things of that nature.

The SEC's guidance also addresses management's internal control disclosures. The same four disclosures are required that have always been required under SOX -- (1) a statement that management is responsible for internal controls, (2) whether management believes internal control over financial reporting is effective, (3) the framework that management used for evaluating internal controls, which, most of the time, is the COSO framework, but it could be others. And then, finally, (4) there needs to be a reference to the auditors' opinion that says the auditors have audited the internal control over financial reporting and issued a report thereon, and indicate where that opinion is located.

One important point that the SEC wanted me to make in another presentation I gave -- and this is something that it has said publicly many times -- the SEC continues to see disclosures that do not adequately describe the nature and impact of the identified deficiency. And I think what the SEC expects is for the disclosure about the weakness to tell the reader enough about the weakness to know what really happened, and how that could impact the quality or the reliability of the organization's financial statements. So if you are disclosing a material weakness, do make sure that you disclose enough about it, and that the disclosure is not so cryptic that a reader looks at it and really can't understand the nature of the material weakness.

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SEC's Guidance – Other Administrative Details

My last slide on the SEC's guidance is just an FYI. The SEC published some new FAQ guidance. Actually, the SEC went through all of its FAQ guidance regarding internal controls and financial reporting and weeded out some that it felt were no longer necessary, or that were now addressed in the interpretive guidance. The SEC then re-numbered the remaining questions. And they added four new questions pertaining to foreign private issuers. Those are FAQs 12 through 15. If you are a Foreign Private Issuer (FPI), or are associated with an FPI, you may want to go onto the SEC's Web site and take a look at that. The next slide shows the Web address for the SEC's interpretive guidance for the COSO guidance.

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SEC/COSO Document Location

Location reminder …

- SEC's Interpretive Guidance for Management
  www.sec.gov/rules/interp/2007/33-8810.pdf
- COSO's Discussion Document — Guidance on Monitoring Internal Control
  www.coso.org

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So that's the end of my overall presentation about the SEC's guidance. I do want to point out that the SEC's interpretive guidance is available on the SEC's Web site. It's under the interpretive guidance section, so you've got to do a couple of clicks to get to it, but that information is up on the screen. In the next presentation we will talk about COSO's guidance on monitoring internal control. You can read more about that project, and download related information, at COSO's Web site, at www.coso.org.

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