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SEC PROPOSES INTERPRETIVE GUIDANCE AND RULE AMENDMENTS REGARDING MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

By Curtis R. Hearn and Joseph P. Roger

On December 20, 2006, the Securities and Exchange Commission ("SEC") proposed interpretive guidance for management regarding its evaluation of the adequacy of internal controls over financial reporting under Section 404 (a) of the Sarbanes-Oxley Act of 2002. The SEC further proposed an amendment to its rules requiring management's annual evaluation of internal controls to clarify that an evaluation that complies with the interpretive guidance will satisfy management's responsibilities under the rules. The SEC also proposed amending its rules to revise the requirements regarding the auditor's attestation report on management's assessment of internal controls.

Proposed Interpretive Guidance

The proposed interpretive guidance is intended to assist management of companies of all sizes to design and conduct its evaluation and assessment of the effectiveness of the company's internal controls. The proposed interpretive guidance does not take a checklist approach as to the steps management should perform in undertaking its evaluation. Rather, it advocates a top-down, risk-based approach where management focuses on whether the company's controls are sufficient to adequately evaluate and address the risk of a material misstatement in its financial statements. The guidance allows for, indeed demands, the exercise of significant judgment by management to design and conduct an evaluation that is tailored to its company's individual circumstances. For example, the proposed interpretive guidance:

explains that approaches for gathering evidence supporting the evaluation will likely vary based on risk assessments;

- explains the utility of ongoing monitoring activities as evidence in the evaluation;
- explains the purpose of documentation in supporting risk assessments;
- provides for significant flexibility in management's judgments regarding what constitutes adequate evidence in low-risk areas; and
- allows management and the auditor to utilize different testing methods as to the adequacy of the internal controls.

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Specifically, the proposed interpretive guidance focuses on an approach identifying primary financial reporting risks, evaluating whether the controls adequately address those risks, evaluating the evidence of the effective operation of the company's internal controls, and the consideration of multiple locations or business units. Included in the process are:

- the consideration, at the entity level, of controls that adequately identify and assess financial reporting risks and related controls for a financial reporting element;
- the consideration of controls that may be automated or IT dependent;
- the maintenance of reasonable support for management's assessment, including documentation of the design and use of the controls;
- the evaluation of the materiality of the various financial reporting items and their susceptibility to a material misstatement (for example, do they involve estimating, are they susceptible to fraud, are complex GAAP rules involved);
- the methods and procedures management uses to gather evidence about the effectiveness of controls; and
- the nature of the evidence which supports management's assessment.

The proposed interpretive guidance also addresses certain reporting considerations such as:

- the evaluation of any control deficiency identified to determine whether the deficiency is a material weakness;
- the disclosure of a clear expression of management's assessment of the effectiveness of the company's internal controls;
- enhanced disclosure that goes beyond the mere acknowledgment of the existence of a material weakness;
- if there has been a restatement of previously issued financial statements, the impact of the restatement on management's report; and
- whether management has been unable to assess certain aspects of the company's internal controls.

The SEC proposes to amend Exchange Act Rules 13a-15(c) and 15d-15(c), which require management to evaluate the effectiveness of the issuer's internal controls, to state that, although there are many different ways to conduct an evaluation of the effectiveness of a company's internal controls to meet the requirement in the rule, an evaluation conducted in accordance with the proposed interpretive guidance would satisfy the annual management evaluation required by those rules.

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Proposed Rule Enhancing Auditor Attestation Requirements

Pursuant to S-X Rule 2-02(f), the auditor's attestation report must clearly state the "opinion of the accountant as to whether management's assessment of the effectiveness of the registrant's [internal controls] is fairly stated in all respects." The SEC proposes to revise Rule 2-02(f) to require the auditor to express an opinion directly on the effectiveness of the company's internal controls, a rule revision that is likely to draw the objection of audit firms. The amendment would also clarify the circumstances in which the SEC would expect that the accountant cannot express an opinion. In addition, the SEC proposed conforming the revisions to the definition of attestation report in S-X Rule 1-02(a)(2).

Comments on the proposed interpretive guidance and proposed rule amendments should be delivered to the SEC no later than February 27, 2007.

Please remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues you may contact the head of our Corporate and Securities practice group:

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