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Perspectives on Management Review Controls: Challenges and Solutions

Insights from a Qualitative Study of the Issues

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Purpose of the Study

This study focuses on subjective, judgment-based management review controls (MRCs) used by management teams of public companies (hereinafter referenced as “preparers” or “organizations”) as part of their efforts to address the risk of material misstatements in financial reporting and to effectively and efficiently provide management with reasonable assurance that internal control over financial reporting (ICFR) is effective. This report provides information and insight useful to preparers, auditors, and regulators on issues surrounding the design, implementation, execution, and documentation of MRCs, including issues in the context of ICFR assessments and attestations under Section 404 of the Sarbanes-Oxley Act of 2002 (SOX). Practices related to the design, performance, and documentation of MRCs vary widely across different organizations. Preparers, auditors, and regulators (e.g., the Public Company Accounting Oversight Board [PCAOB] Division of Registration and Inspections) have all identified this as an area in which opportunities for improvement exist. By gathering experiences and perspectives from preparers and auditors in the field, this study aims to provide a useful window into current practices and areas of concern, as well as challenges that might constructively be addressed by preparers, auditors, and regulators. It also aims to identify ideas and insights that might be implemented by all parties, collectively, to improve an area critical to effective internal control over financial reporting. Although our analysis focuses mostly on the design and implementation of MRCs, some of our observations have broader implications important to the entire system of internal control over financial reporting and the related provisions in SOX.[1]

1 Note: Throughout this paper, SOX and SOX compliance refer to Section 404(a), which addresses the requirement of management to assess the effectiveness of its internal control structure and procedures, and Section 404(b), which requires the public company auditor to attest and report on management’s assessment of ICFR for companies of a certain size.

The objectives of this study include the following:

1. Identify and understand **areas of difficulty** or **particular complexity** in management's design, conduct, and documentation of MRCs and effective practices in dealing with these areas.

2. Identify and understand any common "sticking points" in **auditor perceptions or practices** relating to their evaluation of the operating effectiveness of MRCs.

3. Summarize **good or best practices** that management and auditors have found helpful in addressing those challenges.

Following a brief description of the study and overview of MRCs, we provide an overview of the key findings we observed related to perceived benefits and challenges associated with performing and evaluating MRCs that are part of an organization's ICFR. We then provide a number of suggested actions to be considered by preparers, auditors, and regulators to enhance the usefulness of MRCs and to address some of the challenges that may affect the cost of performing and documenting MRCs.

Description of the Study

The information and insights provided in this report are based on detailed interviews with accounting personnel involved in conducting and assessing MRCs for their respective organizations. For each entity included in our study, we interviewed key accounting personnel involved in three different MRCs affecting different aspects of the entity's internal control over financial reporting. CFOs, corporate controllers, and SOX leaders participated in the interviews as well. We separately interviewed, without management present, the external audit engagement partner and other senior members of the audit engagement team who were involved in auditing the selected MRCs for each organization represented. Examples of MRCs we discussed with preparers and auditors include business performance review controls, controls over asset valuation or expense estimation, and controls over revenue estimation. In total, we conducted 32 separate interviews consisting of 24 interviews of key accounting personnel from eight public companies and eight interviews of audit firm engagement partners and other team members. Although the set of companies from which we interviewed management personnel is small, the eight organizations included in this study represent a variety of industries and reflect a range of companies, from midsize public companies to extremely large global companies. The perceptions we report were consistently held across respondents, which gives us confidence in their generalizability; however, our findings should be interpreted within the limits of the data available to us. We further note that, while we believe that learning from the perceptions of preparers and their external auditors is helpful to being able to address key issues, this study is not intended to be comprehensive. For example, the perceptions of other relevant parties that are not part of this study, including regulators and inspectors, may provide additional insights.

We conducted our interviews using a semi-structured interview approach based on a detailed script. Prior to each interview, the preparer provided information that described the design of each MRC. The interview script provided a consistent overall framework to guide the discussions, but it allowed us flexibility to expand further into issues identified by interviewees, such as whether they perceived that the problems they identified had improved or worsened over time. We prepared detailed notes of each interview, which serve as the basis for this report. We analyzed those notes to identify high-level themes, which, based on our seasoned judgments, represent the key insights we garnered and present in this document. Participating companies, audit firms, and their respective personnel were assured that their participation and information shared would be kept anonymous in order to encourage candor. And, indeed, we were very pleased with the openness and candor of the participants—it was clear that they did not hold back. Additional information outlining our approach is included in Appendix A.

What Are Management Review Controls?

Essentially all internal control systems contain MRCs in some form. For the purposes of this study, we define MRCs as reviews of aggregated financial information or estimates by knowledgeable personnel to detect misstatements at an appropriate level of precision. A single MRC usually involves a string of activities, each of which in turn may be associated with lower-level controls, including controls that address the completeness and accuracy of the underlying information, which often may come from disparate internal and external sources. MRCs cannot exist without information generated from within the organization. Common examples of MRCs include budget-to-actual comparisons, period-over-period comparisons, and reviews of estimates for reasonableness, including estimates of fair value and reviews of potential impairments. MRCs may be performed by an individual, by a series of individuals, or as part of a group review. They typically rely on the completeness and accuracy of underlying information used in the execution of the control. Most importantly, their effectiveness is highly dependent on subjective judgments made by the management reviewers. Consequently, as in any setting where human judgment is employed, biases of and pressures on the reviewers may impact the effectiveness of MRCs. For example, pressure to achieve an earnings target may influence a reviewer to discount negative information and over-emphasize positive information, or fail to consider potential contrary information.

Many important accounting measurements are inherently imprecise and are based on subjective judgments about what the preparer and the reviewer believe to be the best information available to them at the time. Controls over these types of accounting measurements thus unavoidably encompass many similarly subjective judgments. Such subjective judgments create challenges both for control performers and for auditors. In turn, documenting and evaluating judgments made and decision processes used by those who perform MRCs is inherently difficult and subjective for both management and auditors.

To better understand these challenges, with the goal of identifying potential solutions, this study focuses on those MRCs that involve a significant degree of subjective management judgment.

Key Findings

Our findings are based on a subjective synthesis of the interviews and represent common themes shared by preparers and their auditors. We found a high degree of consistency in the views of preparers, even across companies of very different sizes and industry settings, as well as over the time the study was conducted. The tone of the interviews was generally constructive overall, and indeed mostly supportive of the key provisions of SOX and the value of internal controls and related assessment in general. Many preparers commented that, in their view, execution of audits of internal control over financial reporting largely has improved over time. Respondents from smaller companies and from companies that have recently been required to comply with Section 404(b) SOX requirements tended to express greater frustration about costs overall, and to be more critical, especially in the area of MRC documentation expectations. Respondents from larger companies seem to have generally accepted SOX compliance as a necessary and helpful part of doing business and indicated that the SOX-related internal control assessment has been seamlessly integrated into their ongoing processes, though we note consistent thematic concerns in the area of MRCs even in respondents from larger public companies.

Although we relay some criticisms of the current environment and note some opportunities for improvement, readers should not conclude from this report that the preparers and auditors we interviewed believe SOX internal control reporting to be fatally flawed. Rather, we find that most believe SOX has been successful in enhancing financial reporting quality. At the same time, it is clear that these respondents almost unanimously believe that there are aspects of its ongoing and evolving implementation that are reaching a point of diminishing returns and that there may be value in finding ways to streamline and rationalize ongoing efforts to improve processes related to compliance with Sections 404(a) and (b) of SOX. This is perhaps nowhere more true than in the area of MRCs. We believe that preparers, auditors, and regulators all have opportunities for improvement, and that by working together they can overcome the issues identified, making this critically important type of control more effective and efficient.

CONSISTENT THEMES

Interviewees cited important benefits from the requirements related to management assertions about the operating effectiveness of internal control over financial reporting, including MRCs, required by Section 404(a) of the Sarbanes-Oxley Act of 2002 and the related auditor assurances required by Section 404(b) of SOX for accelerated and large accelerated filers. The preparers interviewed often cited benefits stemming from SOX, and the use of MRCs in particular, including the following:

+ Improving management's focus on internal controls
+ Educating more people outside of the finance function in the company about their role in internal control over financial reporting
+ Enhancing internal control over financial reporting
+ Better integrating internal controls into business processes
+ Providing clarity about processes, responsibilities, and accountability, and ultimately facilitating a better understanding of the financials
+ Improving financial reporting, although, as discussed below, the preparers we interviewed believe more recent changes in their processes bring diminishing returns, often with little or no incremental improvement

The benefits that are accrued, especially the more recent incremental ones, come at an increasingly high cost. The preparers consistently cited the following concerns:

+ Diminished emphasis on the principles-based nature of guidance on assessing internal control, including the *2013 COSO Internal Control – Integrated Framework*[2], Securities and Exchange Commission (SEC) guidance for preparers, and PCAOB standards for auditors, substituted by greater weight placed over time on interpretations of auditing standards by PCAOB inspectors. Few preparers cited reliance on SEC guidance issued in 2007; auditors often find themselves educating preparers on internal control requirements as interpreted through PCAOB inspections, with preparers having few alternative sources of guidance to consider.
+ Perceived constant change in what is considered acceptable to regulators, without changes in guidance or standards provided. In particular, preparers cited confusion and rework caused by constantly shifting expectations, practices, and requirements resulting from PCAOB inspections and the resultant increase in costs, wasted resources, and tensions.
+ Inadequate consideration of the impact of constant changes on companies, which has increased costs and created unnecessary tension between companies and their auditors.
+ Diminishing returns in the degree of improvement in internal control from continued shifts in evaluation and documentation practices stemming both from shifting expectations emanating from regulatory inspections of audits and from changes in audit engagement leadership.
+ Constant increases in expected documentation of performance of MRCs, bringing ever-increasing costs without perceived incremental benefit.
+ Interviewees believe these issues are continuing.

Some preparer respondents cited other disadvantages stemming from ever-increasing MRC-related costs, such as the following:

+ Distraction from running the business
+ Costs of resources to design and manage the assessment process
+ Costs of resources to document the design and operation of processes and controls

2 In May 2013, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) published its *Internal Control – Integrated Framework* (2013) (also referred to as the 2013 COSO Framework), which updated its original 1992 framework.

KEY DRIVERS OF COST

The preparers we interviewed believe that excessive documentation expectations with respect to the performance of MRCs beyond what is needed to maintain adequate support for their control assessment is a leading cause of cost and concerns. Often there is a perception on the part of preparers that auditors require that every detail of the data, thought process, discussions, and detailed timelines of steps performed related to the performance of an MRC must be documented. And, because many MRCs involve inherently subjective, complex judgments, creating such increasingly detailed documentation simply leads to more questions that, in turn, require more documentation, creating a spiraling effect. A recurring theme in our interviews was that the chase for more and more detailed and objective documentation of these inherently subjective, judgment-based controls has reached the point of severely diminishing returns, with questionable benefits on the effectiveness of these controls.

Many of the preparers we interviewed perceive that these constantly changing expectations stem from PCAOB inspections. This assertion is echoed by research from Johnson, Keune, and Winchel,[3] who find that PCAOB expectations can drive excessive caution in audit firm practices, and from Aobdia,[4] who documents the spillover effect of inspection findings across engagements. The preparers also cited a disconnect between constantly changing expectations for auditors and older, more principles-based guidance from the SEC for preparers, especially relating to the level of detail required in documentation to provide evidence of performance. Confusion about requirements and constant changes in the expectations of auditors (apparently stemming from perceived changes in inspector expectations, which can also vary across different inspection teams) increases costs and creates friction between preparers and auditors.

Preparers clearly perceive that expectations surrounding MRCs (and other areas of internal control over financial reporting) have elaborated and diverged considerably over time from those initially communicated by the SEC's 2007 guidance for management. Interviewees rarely referred to the SEC's original ICFR guidance for management, instead frequently referencing constantly changing expectations conveyed to them from the PCAOB via auditors. As a result, auditors often find themselves educating preparers on internal control requirements as viewed by the PCAOB, and preparers have few alternative sources of guidance to consider. From this perspective, it is fair to say that the preparers' perception is that the PCAOB is driving the evolution of SOX implementation in the area of MRCs through pressures placed on auditors.

The preparers we interviewed often cited the control environment and other entity-level controls as critical to effective internal control (as indicated in the SEC's 2007 guidance for management and in PCAOB AS 2201, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*), e.g., tone at the top, expertise of management, etc. Auditors tend to not place much reliance on these foundational components of internal control. Rather, auditors tend to emphasize specific, detailed business process control activities. Because assessment of the control environment and other entity-level controls tends to be subjective and outside the comfort zone of auditors and inspectors, the respondents perceive that these higher-level, more subjective aspects of internal control tend not to receive the attention or reliance they deserve. This finding is mirrored by evidence reported by Griffith, Hammersley, and Kadous[5] in their assessment of auditors' approaches to auditing fair value balances, a similarly subjective area. The authors find that auditors sometimes focus more on the detailed aspects of the fair value estimates and less on the overarching control environment or on the critical, judgment-based review of subjective information inherent in the proper functioning of MRCs.

3 L. M. Johnson, M. B. Keune, and J. Winchel, "U.S. Auditors' Perceptions of the PCAOB Inspection Process: A Behavioral Examination," *Contemporary Accounting Review* 36, no. 3 (Fall 2019): 1540–74.

4 D. Aobdia, "The Impact of the PCAOB Individual Engagement Process-Preliminary Evidence," *The Accounting Review* 93, no. 4 (July 2018): 53–80.

5 E. E. Griffith, J. S. Hammersley, and K. Kadous, "Audits of Complex Estimates as Verification of Management Numbers: How Institutional Pressures Shape Practice," *Contemporary Accounting Review* 32, no. 3 (Fall 2015): 833–63.

Additionally, some of the respondents perceive an excessive focus on areas that, although quantitatively material, are of relatively little concern to investors, thereby increasing costs without real benefit to investors. This tends to occur because of a perceived over-emphasis by auditors on materiality as a quantitative concept in the scoping of an audit in response to auditing standards and perceived inspection risk. Although the roots of this issue may lie in accounting and auditing standards, the widespread perception is that auditors pay too much attention, and require management to incur too much cost, on areas that, in management's view, do not matter to their business or to investors or other stakeholders. These perceptions reflect a complex and difficult area, the depths of which are beyond the scope of this paper. But in the end, it is clear that costs incurred for MRCs that are viewed as less relevant to investors or to business operations are perceived much more negatively by management than are costs incurred for other MRCs.

Finally, some preparers we interviewed cited the significant cost of establishing the SOX assessment process and documenting the design of processes and controls. Observations included the following:

+ The costs and work involved often create shock and consternation for companies new to SOX or parts of businesses newly brought into the scope of a SOX assessment.

+ Once established, the ongoing costs simply become part of the cost of doing business, particularly for larger organizations. However, continuing changes in expectations lead to a cycle of ongoing implementation costs.

+ Initial and ongoing costs tend to be particularly problematic for smaller organizations. Respondents representing smaller companies indicated that hiring even a few additional personnel to address process and documentation requirements can be a significant issue. They noted that an increased focus on controls documentation can come at the expense of a focus on running the business.

In sum, preparers are concerned about the costs associated with what they perceive as constantly changing and seemingly disproportionate expectations that can complicate already functional management review controls. Escalating requests for increasingly detailed documentation, especially in view of extreme caution brought about by PCAOB inspections, create a ratcheting effect, leading, in the view of several preparers that we interviewed, to an increasingly untenable situation. Further, although enhancing the design, implementation, and documentation of MRCs that relate to areas of interest to investors or that are relevant to "running the business" is seen by management as a productive investment, ratcheting up the work on other MRCs is perceived as a difficult cost to shoulder given their lack of relevance.

Suggested Actions

KEY ACTIONS FOR PREPARERS

Set the right tone regarding the importance of internal control

Both auditors and preparers in our study perceive that organizations' messaging about the importance of internal control, including the role of MRCs, from the senior executive team, and sometimes from the audit committee or board of directors, makes a difference in the embrace of the importance of internal control and SOX processes. When management encourages "doing things right," there seems to be greater buy-in about the importance of designing, implementing and maintaining, evaluating, and documenting internal controls among the organization's employees. Organizations whose control environments establish that high-quality financial reporting, including SOX compliance, is valued, tend to face less resistance and experience greater efficiencies related to their SOX compliance efforts.

Evaluating an organization's tone at the top and further emphasizing it through overall communications throughout the organization regarding the importance of high-quality financial reporting and the associated SOX compliance process is fundamental to the effectiveness of internal control. Leaders should keep in mind that there is often ongoing turnover and change in individuals involved in the process, and memories can fade. Continuing communication and modeling by management teams in their actions and attitudes can go a long way in helping set a tone of accountability that ultimately leads to greater internal control effectiveness, including the performance of MRCs. Even when the tone at the top is strong, a lack of consistent messaging and reinforcement through the layers of management may ultimately dilute the emphasis on effective internal control. Care should be taken to ensure that the message is heard and consistent throughout the organization and that it is reinforced through observable actions and not just words. Management teams should also monitor the effectiveness of their messaging and evaluate whether their messaging is adhered to by others across the organization.

Create and maintain infrastructure to support SOX compliance

Overseeing all the processes, systems, people, and procedures that collectively comprise management's design and implementation of internal control over financial reporting involves complexity and subjectivity. Added to that is the challenge of coordinating management's process of testing and evaluating the design and operating effectiveness of internal control over financial reporting in order to give management a basis for providing its annual assertion as required by SOX 404(a).

Most of the organizations represented in our interviews had created a SOX coordination function with a dedicated individual or team of individuals responsible for the overall leadership and organization of the entity's SOX compliance process. This individual or team assumes primary responsibility for the coordination of the annual SOX compliance process, including project management, documentation, and training responsibilities. Some organizations also have a SOX implementation committee or working group that helps streamline the SOX assessment processes. Respondents in these companies indicated that centralized leadership of SOX compliance efforts, coupled with the investment in personnel and systems that provide a coordinated effort leads to significant efficiencies and greater effectiveness in SOX compliance. In regard to MRCs, those efforts helped strengthen the understanding of individuals across the organization about important elements necessary for effective performance of MRCs.

Focus on risk and materiality

The assessment of risks of material misstatements in financial reporting is key to determining the sufficiency of evidence needed to evaluate the operating effectiveness of MRCs and other internal controls. The definition of materiality recognizes the importance of a matter to an investor by framing a material amount as one that would change an investor's decision. In practice, materiality is often viewed in quantitative terms for audit scoping decisions. As a result, large amounts tend to be viewed as material even if a relatively large change in the amount would not significantly influence investors' decisions. An example of this often cited by the preparers we interviewed is goodwill impairment. The preparers noted that investors frequently ignore or react little to goodwill impairment because it is a non-cash charge, yet auditors may spend significant time on controls over measuring impairment of goodwill. This, in turn, requires a great deal of preparers' time and effort to document what are often inherently subjective, judgment-based MRCs. In many circumstances, the risk of misstatement as well as the risk of the control failing for a goodwill impairment, may be low. Financial reporting issues that different stakeholders deem important may vary. Nevertheless, consideration of the relationship between materiality and risk may be useful in addressing the issue with respect to the sufficiency of documentary evidence.

SEC guidance for preparers provides some useful insight into this issue by discussing the relationship between materiality and the risk of control failure. Similar guidance might also beneficially be elaborated in future revisions of the 2013 COSO guidance. See Appendix B for excerpts from the SEC guidance. Revisiting the SEC guidance for determining the sufficiency of evidence based on ICFR risk, susceptibility of misstatement, and the risk of control failure may help to address concerns about over-emphasis on certain accounts. SEC and PCAOB staff guidance and speeches, and PCAOB direction to inspectors can more strongly emphasize consideration of the SEC guidance. Examples of applying existing guidance when assessing risk and materiality in the context of MRC effectiveness may be beneficial.

Design internal controls that generate multiple benefits

Organizations perceive greater buy-in, efficiency, and effectiveness to the extent they were able to integrate controls in a way that produced benefits both to run the business and facilitate effective financial reporting. Several preparers we interviewed noted that the level of engagement by business unit leaders in the performance of an MRC, including documenting key judgments and conclusions made by them, is greatest when a given control is important to running the business and decision-making in addition to financial reporting. When business unit leaders rely on controls to make key business decisions, they often better appreciate the importance of testing underlying data and documenting the performance of their key processes. Seeking opportunities to build upon existing business processes and leverage them for financial reporting purposes may lead to increased efficiencies in SOX compliance efforts and greater effectiveness in the performance of MRCs. Thus, where possible, preparers may want to look for ways to integrate the assessment of financial reporting internal controls with business processes.

Consider centralization of controls

We observed some differences in noted SOX compliance benefits for organizations that took a centralized approach to designing and implementing internal control activities across different business units compared with those organizations that took a decentralized approach. Some organizations design and implement internal controls and require all business units (e.g., functions, geographies) to use a prescribed set of internal controls that follow a standardized timeline and process, including those related to MRCs. In contrast, other organizations, particularly those whose growth has largely occurred through merger and acquisition activities, may delegate the design and implementation of internal controls, particularly MRCs, and related management assessments of those controls to the business unit level, thereby allowing internal control processes to differ across business units.

Decentralized environments may create challenges when coordinating the assessment of the effectiveness of MRCs and be more costly, especially when multiple processes, systems, and controls are used for the same business activities across the entity. If centralization is not possible due to the structure of the business or the cost of integration, management should recognize that additional internal control costs are simply part of the cost of doing business in this way rather than the result of onerous SOX requirements. Additionally, decentralized organizations often require greater attention to internal controls simply because they are more complex to control. As a result, management may want to consider whether certain financial reporting controls, including MRCs, can be centralized.

Explore ways to automate MRCs

Because MRCs by definition involve management review and judgment as part of the performance of the control, some aspects of MRCs are inherently people based. Although human components are most likely involved in the performance of an MRC, some organizations are exploring whether some aspects of the MRC could be automated. Some of the underlying data inputs to the MRC or the linkage of steps within the process may lend themselves to automation, including the use of algorithms that leverage expert models to provide additional information to supplement judgments of the person who performs the MRC. For example, prespecified expected ranges of values for data used as inputs to an MRC might flag outlier data for the MRC preparer to consider before performing a review. Organizations are exploring opportunities for leveraging the benefits of technology as part of the performance of the control, including its documentation. For example, some companies are finding value in applying data analytic and visualization technologies to facilitate both the performance and documentation of MRCs.

Capture expertise of experienced individuals

The rich experiences and knowledge individuals obtain over their careers through various roles within the organization often help provide a foundation for making informed judgments when performing a given MRC. The operating effectiveness of an MRC can be enhanced by the seasoned judgment of individuals who perform those controls. Unfortunately, the benefits may be lost when those individuals change positions or leave the organization.

Organizations may want to find ways to capture the expertise of and the decision-making steps taken by experienced individuals who perform MRCs. Doing so may provide opportunities for the training and leadership development of others who may later assume responsibilities for making judgments that are important to a given MRC's effectiveness. Capturing the expertise will not only help with succession planning, but also may lead to opportunities to potentially automate some key MRC processes.

Increase focus and attention on highly subjective judgments

By their nature, MRCs involve subjective judgments by the individuals performing the MRCs. Some organizations involve several individuals in the review of key assumptions and processes that are critical to the performance of an MRC. Often, MRCs may be subject to an established process that involves review by a working group or committee. Having “more eyes” on highly subjective judgments helps offset the potential for unintended bias that might creep in if only one individual is involved. Reducing the effects of bias in the performance of an MRC may help increase the MRC’s precision. Engaging more people across the organization in a systematic way may help improve key judgments, particularly when there are opportunities to create cross-functional teams that include a mix of financial and operational personnel. Cross-functional teams may help detect circumstances where evidence from different inputs may be contradictory.

Focus on underlying assumptions

A number of MRCs, particularly those tied to accounting estimates and valuation judgments, are heavily dependent on a number of underlying elements that include various sources of data, methodologies, and assumptions that can have an important impact on the performance of an MRC. Although the performance of a particular MRC may be based on what appears to be a sound assumption, sometimes a higher-level consideration of a number of MRCs may reveal inconsistencies in assumptions being made across different business units. Identified inconsistencies in assumptions can impact business decisions made by preparers and create difficulties for the audit process and subsequent regulator inspections.

Some organizations embed processes within their consideration of the performance of a given internal control. This serves to reconcile assumptions being made in the performance of an MRC with assumptions being made in other key business decisions. For example, assumptions being made in the financial reporting process about goodwill impairment may be compared to assumptions being made in the strategic planning and budgeting functions for the business unit. Reconciling inconsistencies in assumptions between processes helps minimize inconsistencies and increases the precision of those assumptions, which can have a multiplying benefit when several controls depend on a given assumption.

Establish timelines for control performance

In a number of organizations, we observed a very clear and well-established timeline for the performance of key steps of a given MRC. Timelines with specific and standardized dates for completion (e.g., specific to month end, quarter end, and annual close procedures, well-established expectations for timeliness and accountabilities) helped signal the importance of a given control, and may help provide built-in evidence for the control. Some organizations create specific language for communicating about timelines for the performance of controls. For example, some might refer to the timing of a control to be performed two days prior to a quarter’s close as “q minus 2.”

The establishment of explicit and consistent timelines with little tolerance for deviations from the timeline provides a level of engagement and cadence helpful to the process. Clear timelines also increase capabilities related to project management, communication, and documentation of MRCs that are part of the SOX compliance process. Organizations whose control timelines are not clearly defined may find benefits from enhanced standardization of those timelines.

Consider the nature and extent of documentation of the MRC review

In addition to providing documentation of the actual performance of an MRC, documentation related to the design of the MRC is important because it supports the monitoring process as required by COSO 2013. The nature and extent of documentation about the design of an MRC helps preparers and auditors better understand the overarching purpose and objective of the MRC, which is critical to assessing whether the MRC is effectively designed to address the intended risk of material misstatement. Documenting what is entailed in the MRC’s performance, such as information about what inputs are used, what steps are performed, and what criteria are used as part of the MRC evaluation, as well as what is within and outside the MRC’s scope, not only helps improve the performance of the MRC but also assists auditors in their evaluation of the audit evidence needed.

Educate and train on an ongoing basis

The level of investment and engagement by individuals involved in processes that support the performance of an internal control are dependent on their understanding of the importance of high-quality internal controls and the processes they are to perform to support a given control's intended purpose. Although most organizations have provided some form of education and training regarding internal controls and the underlying processes to be performed, that training may have been limited to individuals in financial reporting roles even though many controls also involve or are impacted by individuals in nonfinancial roles. Additionally, given the ever-present reality of turnover in personnel involved in a process, infrequent education and training may result in individuals who have not been formally trained in regard to their roles, the risks that the controls are designed to address, and how they should evidence judgments made as part of their performance of the MRC.

The benefits of providing ongoing and regular training focused on the importance of high-quality financial reporting and related internal controls, in addition to coaching on how to perform related processes important to a given MRC, may outweigh the costs incurred. Training should also include on-the-job performance feedback to individuals involved in performing an MRC. Over time, this feedback loop provides a quality improvement mechanism for control performers. Because MRCs are inherently subjective and often require complex estimation and judgment, a systematically designed feedback loop of this kind can be especially important in calibrating future iterations of processes involved in MRC execution.

Foster open and regular dialogue with external auditors

We observed across our interviews a consistent theme of tremendous benefits when organizations and their auditors establish an open, early, and ongoing communication process with one another. Several interviewees commented on the significant benefits they realized as the level of dialogue and information sharing between auditor and management increased.

Engaging in early, upfront planning conversations as a part of each annual financial reporting cycle helps establish and update performance expectations that might have changed since the prior year. Clarifying changes in control performance processes and related documentation expectations at the beginning of a reporting cycle appears to greatly help both management and the auditors level-set their collective understanding of key expectations and deliverables. It also provides a forum to share learnings from the prior year and knowledge about emerging best practices. Establishing expectations early in the reporting cycle helps organizations avoid having to re-create documentation subsequent to the initial performance of a control. It also helps management build changes in expectations in how an MRC is performed and documented as part of the normal workflow.

Maintaining an ongoing dialogue with auditors also provides opportunities to inform auditors in a timely manner of changes that naturally happen in a business over time. As events occur (e.g., an acquisition), aspects of internal control may change. Engaging in discussions early on about how such changes might affect the quality of a key MRC can lead to later efficiencies as the audit process unfolds. Pinpointing beneficial tweaks to a control sooner versus later can make the process go significantly smoother in the long run.

Invite auditors to observe management meetings

An interesting observation from our interviews is that some organizations invite external auditors to observe company meetings where management engages in discussions and makes decisions that serve as a primary component of a given MRC's performance, where key assumptions that underlie an MRC are discussed, or where a business judgment is made that is an important input to the MRC. Allowing auditors to observe management's discussions and decision-making activities provides them an opportunity to evaluate internal control components, including aspects of the control environment, in action. Doing so also allows them to see firsthand the level of engagement among individuals, the perceived quality of the discussions, and the overall tone at the top. The firsthand knowledge obtained by the auditor also helps them in their documentation of some of the key elements of their evaluation of the operating effectiveness of management's control performance, lifting some of the control documentation burden from the preparer. Ultimately, this practice allows the auditor to directly observe the performance of the control rather than relying solely on documentary evidence that otherwise often needs to be extensive. The auditor's presence should be solely as an observer of the process and thus should not imply that the auditor is now a part of the management review control itself.

A key to the success of this approach is to establish an understanding among meeting participants that management should maintain transparency and candor in the auditor's presence. Providing explicit guidance about the importance of transparency is particularly important when first involving auditors in a management meeting. Auditors also have to be conscious of how their body language and interactions while in the meeting might impact the process, and should remember that they are participating only as an observer. All parties need to approach this level of engagement with a commitment that the presence of an auditor in a management meeting is important to the quality of management's financial reporting process and the quality of the auditor's assessment of the effectiveness of the MRC. The benefits will be diminished or eliminated if management discussions are stifled or if less desirable actions begin to emerge (e.g., holding a pre-meeting without the auditor present to agree on decisions to be made in the formal meeting with the auditors present).

KEY ACTIONS FOR AUDITORS

Be clear about expectations at the outset

The preparers' number one recommendation for improving the audit process is for the auditor to be clear about expectations from the beginning and to remain consistent. Reworks, surprises, and avoidable disruptions create cost and irritation for all. The preparers we interviewed also said that surprises seemed to come with changes in audit engagement leadership or were attributed to audit firm changes made in response to inspection findings that emerge from across the audit firm's collective engagements. The most common area for changes that brought frustration is the extent of documentation of MRC performance.

A practice that several auditors find helpful in addressing this challenge is to, before audit work begins, hold a planning session that encompasses all the significant participants in the process. Interviewees from companies that have held these planning meetings noted that they help provide a timely communication where expectations and changes to the process from the prior year can be made clear, discussed, and agreed on in advance. No doubt few people would disagree with this description as an ideal, but the realities of scheduling, differing views about requirements, and a host of other reasons may serve as obstacles to effective planning. However, having a clear agreement on what is to be done up front is key to avoiding unnecessary tension— after-the-fact changes in expectations regarding the MRC design, performance, and documentation was the greatest source of frustration for preparers.

Communicate clearly and timely

Along with setting expectations up front, both the preparers and the auditors we interviewed mentioned the need to anticipate issues and communicate clearly and in a timely manner among management and the audit firm. Appropriate supervision and timely review of audit work will enable engagement teams to better identify issues for discussion. When reviews take place over an extended period, rework and repetitions of issues discussed earlier tend to occur. Again, although upfront planning and communication are obvious actions to take and have been part of firm approaches for many years, preparers and auditors often cite issues on both counts. Both parties suggest having regular conversations about expectations and issues. These practices are both fundamental and crucial to avoiding wasted effort and frustration.

Reconsider the extent of documentation needed

Because documentation, particularly documentation of the performance of controls, is a key issue among preparers, auditors taking a close look at what is really needed on an engagement-by-engagement basis will help. From our interviews, it is clear that, over time, excessive expectations for detailed, objective documentation have accumulated around subjective, judgment-based MRCs. Documentation is seldom eliminated but frequently expanded each year. For example, audit documentation often will include descriptions of the experience and qualifications of control performers. This information is reasonable, and a part of the evidence needed to assess effectiveness, but often this documentation may include unnecessary information, such as what school the performer attended or what academic degrees he or she holds. The important information to include is an assessment of the performer's relevant experience, understanding, and insight.

The PCAOB inspections process has led auditors to conclude that they are required to document the *precision* of every significant judgment, decision, or review procedure performed by the company's personnel in conducting an MRC. If the company does not provide the necessary documentation, auditors feel the need to create their own documentation. Otherwise, the lack of documentation is interpreted to mean the judgment, decision, or review procedure was not performed.

Assign appropriately experienced personnel

Due to the subjectivity and complexity of MRCs, experienced audit personnel should be assigned to conduct interviews and evaluate evidence of the performance of MRCs.

Rethink the approach to the control environment

The preparers we interviewed perceived that auditors have a tendency to place little or no reliance on the control environment because of the difficulty of measuring precision and making a substantive assessment of its effectiveness. Yet, as the 2013 COSO Framework makes clear, the control environment is vital to the effectiveness of internal control. Regulators, preparers, and auditors need to devote new effort to develop methods of evaluating and documenting the control environment that will provide evidence of its effectiveness. Where the control environment is strong, the reliability of MRCs may be enhanced. On the other hand, where the control environment is weak, greater testing may be needed on lower-level controls, and MRCs may be less reliable.

Minimize disruptions when changing policies and methodologies

Change can be disruptive. Unnecessary change can be avoided and necessary change can be made in an orderly way. When audit firms consider changing policies or methodologies, the disruptive impact on their audit engagement teams and the preparers' processes and systems likewise should be carefully considered. Setting clear expectations up front can happen only if changes to audit firm policies and methodologies are implemented in a thoughtful, timely, and controlled manner. Time needs to be taken to develop, field test, educate, and explain changes to preparers.

KEY ACTIONS FOR REGULATORS

Calibrate the inspection process

Many preparers and auditors we interviewed perceive diminishing returns from increased documentary evidence. Many believe the ever-increasing demand for detailed documentary evidence is linked to the inspection process conducted by the PCAOB. Auditors and PCAOB inspectors naturally seek documentary evidence, given their training and experience as well as the requirements of PCAOB auditing standards. When faced with subjective judgments, auditors and inspectors tend to seek evidence that is more objective and may equate documentary evidence as more objective. This is a natural and appropriate tendency but, when carried too far, results in creation of unnecessary documentation that, when dealing with inherently subjective, judgment-based controls, may not provide better evidence than other approaches, such as observation and corroborative inquiry.

Auditors seek to follow the PCAOB auditing standards, which drive the primacy of documentary evidence. But audit firms and individual auditors also often quickly react to PCAOB inspection findings. Auditors may respond to inspection findings concerning insufficient evidence by requiring additional documentation of the performance of controls. As a result, inspections may in essence create new de facto control and documentation requirements, with variation across inspection teams. Some of the preparers and auditors we interviewed indicate that these expectations may go beyond the requirements of the PCAOB auditing standards. More likely, these expectations are consistent with the auditing standards but are at a more detailed and specific level than might be useful in the context of inherently subjective, judgment-based controls.

These de facto requirements arising from PCAOB inspections create a ripple effect, as audit firms then build them into their methodology guidance, tools, and training to ensure the requirements are met across all engagements, not just the inspected engagements. And to avoid receiving future comments on other engagements, audit firms and individual auditors may decide to interpret inspection comments even more stringently than intended. This ripple effect may exponentially multiply the change in behavior beyond what was intended. In some circumstances, such rippling changes may work to the benefit of investors by improving audit and internal control quality. However, these changes may also lead to ever-increasing costs without commensurate benefits.

PCAOB leadership (the Board) should be mindful of creeping informal de facto requirements resulting from regulatory inspections and carefully consider whether such requirements reflect the Board's intentions. The PCAOB should also consider improved informal communication with audit firms about the degree and nature of behavior change they are attempting to achieve through their comments. The Board may also consider how to level-set an understanding of their requirements across the various PCAOB inspections teams to avoid a continual *ratcheting effect*, where expectations and costs continually rise or differ without corresponding enhancements in financial reporting quality.

There is a natural tendency for any inspection process to seek to continuously improve and to find deficiencies. That is true for the audit process as well. By monitoring the impact of these continuous improvement efforts and calibrating the two processes, diminishing returns can be kept at a balanced level. An important area to consider in this regard is to articulate and calibrate the expectations for MRCs when new auditing standards are issued.

Rethink the role of documentary evidence in the process

PCAOB auditing standards place a high level of emphasis on documentary evidence by cautioning against *auditing by inquiry* and viewing a lack of documentation as a lack of performance. Auditors in turn often consider lack of documentation of the performance of a control to mean that the control was not effectively performed. Lack of documentary evidence of the performance of a control certainly increases the difficulty of auditing. But an over-emphasis on documentary evidence to the exclusion of other forms of evidence, such as observation and inquiry, causes documentation to be created that may not serve a useful purpose. Initialing a document provides documentary evidence that a reviewer saw the document, but it provides no evidence of the quality of the review that took place. Similarly, documentary evidence alone may not provide much insight into the quality of judgments, especially in the context of inherently subjective, judgment-based MRCs. Requiring ever more detailed documentation of subjective judgments may do little or nothing to improve the quality of those judgments. This ongoing reality fuels the view that further internal control documentation requirements for MRCs produce diminishing returns.

Observation and inquiry are key sources of information on which to judge the effectiveness of controls, especially those like MRCs, which involve significant subjectivity and judgment. For example, attending meetings where MRCs are performed may provide auditors far better evidence of the performance of the control than examining calendar invitations, slides presented at meetings, and participants' educational attainments. In such cases, auditors can conduct thoughtful interviews of control performers so as to gather additional evidence of the effectiveness of the control.

Acknowledging the importance of other forms of evidence that are appropriate for settings involving inherent subjectivity, and framing documentary evidence as one source of evidence rather than the sole source of evidence, could help mitigate continuing pressure to create increasingly detailed documentation simply for the sake of having it.

Reconsider the ability to rely on the control environment in practice

The 2013 COSO *Internal Control - Integrated Framework,* the PCAOB's auditing standards, SEC guidance for preparers, and audit firm guidance all emphasize the importance of the control environment to the effectiveness of internal controls. The preparers we interviewed strongly emphasized the importance of the control environment. They expressed frustration that having a strong control environment is not sufficiently reflected in the auditor's assessment of risk of a control failure. In other words, a poor control environment is seen as appropriately diminishing the effectiveness of control activities, but a strong control environment is not perceived to result in a lower risk of failure of control activities in the auditor's assessment.

To appropriately recognize the effect of the control environment in practice, approaches to assessing the control environment in a persuasive way need to be developed. Approaches to assess and document the control environment will, out of necessity, require subjective, judgment-based processes and documentation. Development of such approaches should be done in a cooperative manner between auditors and preparers and with the involvement of the PCAOB.

Re-emphasize the importance of COSO and SEC guidance for preparers

Three primary sources provide guidance on assessing internal control: the 2013 COSO Framework, SEC guidance for preparers, and PCAOB standards and other PCAOB guidance for auditors. These sources are written at different levels of detail and for different purposes and audiences. All were intended to be principles based in order for the guidance to be scalable and to facilitate the use of judgment by preparers and auditors, and to allow for consideration of a company's individual facts and circumstances. The SEC and PCAOB placed a great deal of emphasis on the alignment of the SEC's guidance for preparers and the PCAOB's guidance for auditors, and both sets of guidance were considered aligned in 2007 when issued. However, our interviews suggest that alignment has eroded over time in the practical application of the guidance.

In particular, both management and auditor interviewees noted that the principles-based guidance has not been able to withstand the authoritative weight of interpretations of auditing standards by PCAOB inspectors and staff. As a result, management generally is forced to rely on PCAOB standards and auditor interpretations of those standards, as well as the perceived requirements and guidance that emerge from PCAOB inspections that are reflected in audit firm guidance, training, and tools. This all contributes to the perception that gaps exist between guidance for preparers and auditors, which contributes to confusion, misunderstanding, and unhealthy tension. Auditors are often placed in the uncomfortable position of serving as the primary communication source about perceived changes in expectations related to management's performance and evaluation of internal controls.

The three areas addressed in this study—documentation, control environment, and the importance of an account to investors—need better alignment among the SEC, PCAOB, and COSO. Such alignment may be accomplished through a variety of informal means, particularly through illustrative examples. However, in our view, changes at the auditing standards level or in SEC guidance are unnecessary and should be avoided because such changes run the risk of creating new confusion.

Recommendations for Approaches to Change

Changes in expectations for control performance, documentation, and auditing of ICFR often lead to misunderstanding, rework, and confusion for preparers and auditors. But the disruption caused by changes can be minimized when they are well thought out, incorporate input from all concerned parties, and are tested before being implemented. For example, when communicating about inspections and the formulation and interpretation of auditing standards, PCAOB representatives should consider the balance between the effectiveness of documentation and efficiency, be willing to provide constructive comments on auditor illustrative documentation about what is generally NOT needed as well as what should be added. PCAOB representatives should also take steps to ensure that staff representing both the inspections and standards-setting functions of the PCAOB espouse consistent points of view.

Preparers, auditors, inspectors, regulators, and other evaluators should recognize that sometimes the best evidence of subjective, judgment-oriented processes is itself subjective in nature. No matter how diligent and well intentioned the changes may be, the difficulties that may result cannot be anticipated without input from the affected parties and field testing. Establishing an understanding of that reality among these key players may help level-set expectations about the extent of testing that is deemed reasonable.

Organizations generally need time to make changes to processes in an orderly fashion and ensure that the revised processes are working effectively and efficiently. This is particularly difficult to accomplish when the changes are incremental and do not follow an understood process of vetting. Expectations of auditors and regulators should reflect an understanding that implementations of change take time and need to be enacted at a reasonable pace so that organizations can absorb the changes without undue cost and disruption. Establishing clear and reasonable timeline expectations of regulators about the speed of implementation would help both preparers and auditors know what to expect and how to prioritize the implementations of change.

Although there is always a danger of prescribing overly detailed requirements, expected changes should be clearly explained by regulators and illustrated at a level detailed enough to be useful to both auditors and preparers. Field testing will greatly assist in developing useful illustrations.

For audit firms, changes in firm audit methodologies and policies should be measured and not immediately reactive to the latest inspection findings. Hastily developed changes may not be accompanied by adequate communication and training and may be unnecessarily difficult and disruptive to preparers. Although there is an understandable desire to correct alleged deficiencies in audit performance quickly, expectations for a fast response by a firm may inadvertently lead to knee-jerk reactions that produce less-than-optimal changes in audit methodology. Firms need to take the time to consider and to effectively and efficiently implement changes. Any approach to change would be enhanced by open communication between firms and the PCAOB about what is a reasonable expectation for the rate of change for noted deficiencies. Some changes may require more immediate attention than others.

A PATH FORWARD

We hope this report provides information and insight useful to preparers, auditors, and regulators on issues regarding the implementation and documentation of MRCs. We believe the collective insights based on experiences and perspectives from preparers and auditors in the field provide a useful window into a number of opportunities and actions to be considered by preparers, auditors, and regulators that can help illuminate a path forward for enhancing the role of MRCs in strengthening financial reporting. We are grateful to all respondents, who generously gave their valuable time to provide perspectives, experiences, and ideas with a spirit of overall quality enhancement.

Appendix A: Description of the Study

This study was jointly commissioned by the Center for Audit Quality and the Financial Education & Research Foundation of the Financial Executives International to help address challenges associated with the performance of management review controls (MRCs) that are a key element of a company's internal control over financial reporting.

The information provided in this report is based on detailed interviews with key accounting personnel who are heavily involved in conducting management review controls for their organization. For each preparer included in our study, we interviewed key accounting personnel who are involved in three different MRCs affecting different aspects of the company's internal control over financial reporting. We separately interviewed engagement partner and other senior members of the audit engagement team for each organization without management present.

INTERVIEWS OF KEY ACCOUNTING PERSONNEL AND AUDITORS

In total, we conducted 32 separate interviews consisting of 24 interviews of key accounting personnel across eight public companies and eight groups of audit engagement partners and other team members. The eight organizations that volunteered to be included in this study come from a variety of industries and reflect a range of company sizes, from small to midsize public companies to extremely large global companies. The interviews were conducted between April 2018 and October 2019.

We assured anonymity to all interviewees involved in this study, including the identification of the organizations and audit firms represented in this study. All organizations involved meet the definition of *large accelerated filer* and therefore are subject to the required management assessment about the operating effectiveness of the entity's internal controls over financial reporting required by Section 404(a) of the Sarbanes-Oxley Act of 2002 (SOX) and the related auditor assurance about the operating effectiveness of those controls required by Section 404(b) of SOX.

Table 1 on page 23 is a summary of some overall characteristics of the companies involved in this study.

TABLE 1

CHARACTERISTIC	RANGE
Total Revenues	$50 million to just under $75 billion
Total Assets	$2 billion to $140 billion
Industries	Banking, Chemicals, Real Estate Investment Trusts, Oil and Gas, Technology - Software & Hardware
Stock Exchange	4 NYSE; 4 NASDAQ
Multinational	6 multinational; 2 US only
Auditors	7 participants were audited by a Big Four firm; 1 was audited by a national firm

We used a semi-structured interview approach based on a detailed interview script to conduct all of our interviews. Prior to each interview, each company provided high-level background information that described the design of each MRC discussed. The interview script provided a guide for our discussions, but allowed flexibility to expand deeper into issues identified by interviewees.

FOCUS ON MANAGEMENT REVIEW CONTROLS

We held an introductory call with the key contacts, which usually involved one or more individuals, including the chief accounting officer, SOX compliance officer/leader, chief financial officer, or other key coordinators of the SOX compliance work for the company. During that meeting, we described the nature of the types of MRCs on which we wanted to focus in our subsequent interviews. We provided the following examples of the types of MRCs desired:

1. An MRC that involves a business performance control, budget-to-actual analysis, or other type of high-level period-to-period or other trend analysis (e.g., sales by region, store, or product line)

2. An MRC that involves the high-level review of an estimation process related to some kind of asset/expense analysis (e.g., goodwill impairment, receivable reserves, inventory valuation)

3. An MRC that involves revenue estimations (e.g., percentage of completion analysis, allocation of product and service revenue components of sales, new/updated processes implemented in connection with the new revenue recognition standard)

We mutually agreed on the MRCs that would be the focus of each interview. We asked each company to provide a brief written description of each of the controls that would be the focus of the interviews. This included not only a high-level description of the design of the MRC, but also documentation of specific steps to be performed when conducting the MRC, including any examples of criteria, guidelines, or judgment rules used to guide the reviewer in performing the control. We also received information about the individual(s) who typically performed the controls and examples (redacted) of any documentation generated as the MRC is performed. The goal of receiving this information in advance was to help our interview team obtain a high-level background understanding about the controls prior to the interview calls.

FOCUS OF OUR INTERVIEWS

Separate interviews were held for each of the three MRCs selected for each participating company. We conducted each interview by conference call with the relevant key accounting personnel involved in the MRC's performance. This allowed us to have indepth discussions to discuss a series of questions centered on these key themes:

1. **Overall Importance of the Control**: Interviewees were asked to provide a description of the overall relevance and importance of this control for the organization and its overall importance to financial reporting.

2. **Precision in the Control**: Interviewees were asked how those involved in the performance of the control determine the level of precision and accuracy desired and achieved when performing the control.

3. **Accuracy of Data Inputs to Control**: Interviewees were asked about processes performed to ensure the data used to perform the control are validated for accuracy and completeness.

4. **Information Provided by Control**: Interviewees were asked how output from this control is used and what is done to track issues that require resolution.

5. **Documentation**: Interviewees were asked to describe the level of documentation related to the control and to describe how that documentation is used (or provides value to management) in running the business.

6. **Improvements Needed**: Interviewees were asked to describe any thoughts about how the MRC had already been or might be improved.

In addition to interviews of key accounting personnel involved in the performance of each of the three MRCs that were the focus of our interviews, we conducted interviews with the audit firm engagement partner and other senior engagement team personnel. No company personnel were present when we conducted these interviews. The purpose of these interviews was to explore the same topics listed above but from the external auditor's perspective. We particularly sought to obtain insights from the audit engagement leaders about the level of engagement of management in the performance of these MRCs, what issues, if any, had emerged related to the performance of the MRCs, whether misstatements have occurred that were not detected by the MRCs, the robustness of management's documentation of the MRCs, reliability of underlying data, and other challenges observed by the audit firm, among other matters.

BASIS FOR THIS REPORT

We prepared detailed notes of each interview, which collectively served as the basis for this report.

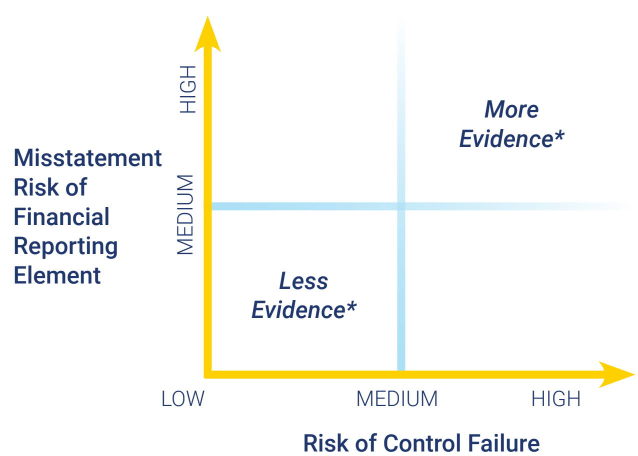
Appendix B: SEC Guidance on Risk and Materiality Related to Controls

In June 2007, the Securities and Exchange Commission (SEC) issued its Commission Guidance Regarding Management's Report on Internal Control over Financial Reporting under Section 13(a) or 15(d) of the Securities and Exchange Act of 1934 (the SEC Management Guidance) [Release Nos. 33-8810; 34-55929; FR-77; File No. S7-23-06]. That release sets forth an approach for management to conduct a top-down, risk-based evaluation of internal control over financial reporting.

The SEC Management Guidance notes that the procedures management uses to gather evidence about the operation of controls should be tailored to its assessment of internal control over financial reporting (ICFR) risk. ICFR risk consists of two components:

1. The susceptibility to material misstatement of the financial reporting elements to which the identified controls relate, which also considers the materiality of the element
2. The risk that controls will fail to operate as designed

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).*

As illustrated by the diagram above, the combination of these two factors impacts the need for evidence to evaluate the effectiveness of internal controls over financial reporting. As both the risk of misstatement and the risk of control failure increase, the need for management to gather more sufficient evidence increases.

Susceptibility of Misstatement: Page 25 of the SEC's Guidance notes, "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 the financial reporting element increases in relation to the amount of misstatement that would be considered material to the financial statements, management's assessment of the 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…[T]he 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."

Risk of Control Failure: Management's evaluation of the likelihood that internal controls over financial reporting might fail to operate effectively involves consideration of factors such as the type of control (e.g., manual or automated) and the frequency of its performance, the complexity of the control, the risk of management override, the competence of personnel who perform the control or monitor its performance, and the judgment required to operate the control, among other matters.

The guidance also provides considerations for when management's direct involvement with and direct supervision of the execution of controls can be a source of evidence of operating effectiveness. Therefore, in those circumstances, management may need to perform only limited additional procedures, if any, to gather evidence of operating effectiveness.

Impact on Need for Sufficient Evidence: Management's evaluation of ICFR risk informs its decisions regarding the methods and procedures necessary to obtain sufficient evidence of the operating effectiveness of controls. As ICFR risk increases, more evidence is expected to support management's conclusion.

Furthermore, management evaluates the evidence it gathers to determine whether the operation of the control is effective. Considerations in making this determination include the following: (1) whether the control operated as designed; (2) how it was applied; (3) the consistency with which it operated; and (4) whether the personnel performing the control possess 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.

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