

July 13, 2007

SEC Adopts Final Rules and Publishes Interpretive Guidance for Management Regarding its Evaluation of Internal Control over Financial Reporting

On June 20, 2007, the SEC issued a final rule release, which will be effective August 27, 2007, containing amendments to SEC rules relating to the evaluation of internal control over financial reporting (“ICFR”).¹ On June 20, 2007, the SEC also released interpretive guidance, which was effective on June 27, 2007, for management to use in its evaluation of ICFR.²

The amendments contained in the rule release include:

- an amendment to Rules 13a-15(c) and 15d-15(c) under the Securities Exchange Act of 1934 to the effect that a management evaluation of ICFR conducted in accordance with the new interpretive guidance would satisfy the evaluation requirements in those rules, although such an evaluation would not be the only type of evaluation that would satisfy such requirements;
- an amendment to Rule 2-02(f) of Regulation S-X (along with conforming amendments to Rule 1-02(a)(2) of Regulation S-X) to the effect that an auditor, in its required attestation, would be required to express an opinion directly on the effectiveness of a registrant’s ICFR, rather than to express an opinion only as to whether management’s evaluation was fairly stated; and
- an amendment to Exchange Act Rule 12b-2 and Rule 1-02 of Regulation S-X to define a “material weakness” as “a deficiency, or a combination of deficiencies, in ICFR such that there is a reasonable possibility that a material misstatement of the registrant’s annual or interim financial statements will not be prevented or detected on a timely basis.”

The interpretive guidance associated with the rule changes is intended to assist management of companies of all sizes to complete their annual evaluation in an effective and efficient manner and references a number of areas commonly cited as concerns over the past two years. The interpretive guidance:

¹ The final rules can be found at <http://sec.gov/rules/final/2007/33-8809.pdf>.

² The interpretive guidance can be found at <http://sec.gov/rules/interp/2007/33-8810.pdf>.

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

On May 24, 2007, the Public Company Accounting Oversight Board adopted a new auditing standard for ICFR, Audit Standard No. 5 (“AS 5”), which will replace the current Audit Standard No. 2 (“AS 2”), and the SEC has solicited comments on AS 5, which period ended on July 12, 2007. AS 5 will likely be approved by the SEC shortly.³ Prior to the time that AS 5 is effective, AS 2 will continue to govern audits of management’s assessment of ICFR, and registrants will be permitted to file whatever auditor’s attestation report they receive, whether it conforms to AS 2 or the expected AS 5.

In conjunction with the interpretive guidance and rule amendment, the SEC has also issued a release soliciting comments on a definition for “significant deficiency” to assist management in effectively evaluating ICFR.⁴ “Significant deficiency” would be defined as “a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of a registrant’s financial reporting.”⁵ The “significant deficiency” proposal is subject to a 60-day comment period.

The final guidance embodied a number of changes to the proposed guidance that were highlighted by the SEC. Attached as Annex A to this memorandum is a summary of certain of the changes highlighted by the SEC.

Key Points

The following are key points to keep in mind in approaching the new rules and guidance:

- The interpretive guidance only provides one method (among many possible methods) for the evaluation of whether ICFR is effective at providing “reasonable assurance”⁶

³ The definition of “material weakness” contained in AS 5 (as adopted by the PCAOB) conforms to the definition adopted by the SEC.

⁴ The proposal can be found at <http://sec.gov/rules/proposed/2007/33-8811.pdf>.

⁵ The definition of “significant deficiency” contained in AS 5 conforms to the definition proposed by the SEC.

⁶ “Reasonable assurance” and “reasonable detail” mean “such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs.”

regarding the reliability of financial reporting and the preparation of financial statements in accordance with GAAP.

- The purpose of the evaluation of ICFR by management is to provide it with a reasonable basis for its annual assessment as to whether any “material weaknesses” in ICFR exist as of the end of the fiscal year.
- A “material weakness” is a deficiency, or a combination of deficiencies, in ICFR such that there is a reasonable possibility that a material misstatement of the registrant’s annual or interim financial statements will not be prevented or detected on a timely basis. Use of the phrase “reasonable possibility” rather than “more than remote” to describe the likelihood of a material error is intended to more clearly communicate the likelihood element.
- Management’s evaluation is performed as of the end of the fiscal year, but the evaluation of ICFR deals with the possibility of misstatements in both annual and interim financial statements.
- Management should implement and conduct an evaluation that is sufficient to provide it with a reasonable basis for its annual assessment. Management should use its own experience and informed judgment in designing an evaluation process that aligns with the operations, financial reporting risks and processes of the company.
- Entity-level controls should be considered in evaluating controls related to specific financial reporting elements.
- Once management has identified a control or set of controls that adequately addresses a financial reporting risk, management need not identify more controls that address that risk. Management may also consider the efficiency with which evidence of the operation of a control can be evaluated when identifying the controls that adequately address a financial reporting risk. When more than one control exists and each adequately addresses a financial reporting risk, management may decide to select the control for which evidence of operating effectiveness can be obtained more efficiently.
- If the evaluation process identifies material weaknesses that exist as of the end of the fiscal year, such material weaknesses must be disclosed in management’s annual report with a statement that ICFR is ineffective. If management’s evaluation process identifies material weaknesses, but all material weaknesses are remediated by the end of the fiscal year, management may exclude disclosure of those from its assessment and state that ICFR is effective as of the end of the fiscal year. However, management should consider whether disclosure of the remediated material weaknesses is appropriate or required under Item 307 or Item 308 of Regulation S-K or other SEC disclosure rules.
- If the evaluation identifies no internal control deficiencies that constitute a weakness, management can assess ICFR to be effective.
- Although management is responsible for the Section 404 process, the SEC would expect a board, or its audit committee, as part of its oversight responsibilities for the company’s financial reporting, to be “reasonably knowledgeable and informed about

the evaluation process and management’s assessment, as necessary in the circumstances.”

- Foreign registrants are not exempt from the ICFR reporting requirements, regardless of whether they are subject to similar home country requirements. The SEC does not believe it is appropriate to exclude a foreign registrant’s U.S. GAAP reconciliation from the scope of the evaluation.⁷
- Existing FAQs relating to ICFR will be reviewed and updated as appropriate.

Guiding Principles

The interpretive guidance is intended to assist management of companies of all sizes to complete their annual evaluation of the effectiveness of ICFR in an effective and efficient manner using a principles-based, top-down, risk-based approach that permits the exercise of judgment by management. An evaluation that complies with the interpretive guidance is one way to satisfy the ICFR evaluation requirements of Rules 13a-15(c) and 15d-15(c) of the Exchange Act.

The interpretive guidance embodies two broad principles.

First, management should evaluate whether it has implemented controls that adequately address the risk that a material misstatement of the financial statements would not be prevented or detected in a timely manner. There is no requirement that management identify every control in a process or document the business processes impacting ICFR. Rather, the interpretive guidance sets forth an approach allowing management to focus its evaluation and documentation process on those controls that it determines adequately address the risk of a material misstatement of the financial statements. Once management has determined that a risk is adequately addressed, no further evaluation of other controls is required.

Second, management’s evaluation of evidence about the operation of its controls should be based on its assessment of risk. The interpretive guidance allows management to align the nature and extent of its evaluation procedures with those areas of financial reporting that pose the greatest risks to the production of reliable financial statements. The intended result is that management will be able to use more efficient approaches to gathering evidence, such as self-assessments, in low-risk areas and perform more extensive testing in high-risk areas.

The Evaluation Process

A. Identifying Financial Reporting Risks and Controls

The evaluation begins with the identification and assessment of the risks to reliable financial reporting (*i.e.*, materially accurate financial statements), including changes in those risks. Management then evaluates whether it has controls in place that are designed to adequately address those risks. Management ordinarily would consider the company’s entity-level controls in both its assessment of risk and in identifying which controls adequately address the risk. The controls that management identifies as adequately addressing the financial reporting risks are then subject to procedures to evaluate evidence of the operating effectiveness, as determined as described below under “Evaluating Evidence of the Operating Effectiveness of ICFR.”

⁷ The SEC has instructed the Staff to consider whether foreign registrant implementation concerns and issues should be addressed in a FAQ document in the future.

After the first year of compliance, for most companies, management's effort should ordinarily be significantly less because subsequent evaluations should be more focused on changes in risks and controls rather than identification of all financial reporting risks and the related controls. Further, in each subsequent year, the evidence necessary to reasonably support the assessment will only need to be updated from the prior year(s), not recreated anew.

1. Identifying Financial Reporting Risks

Management should identify those risks that could, individually or in combination with others, result in a material misstatement of the financial statements ("financial reporting risks"). Ordinarily, the identification of financial reporting risks begins with evaluating how the requirements of GAAP apply to the company's business, operations and transactions.

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

The methods and procedures for identifying financial reporting risks will vary based on the size, complexity, and organizational structure of the company and its processes and financial reporting environment. In contrast to a large company, in which management may need to involve employees with specialized knowledge and understanding of company processes and the business in general, in a small company with less complex business processes that operate on a centralized basis and with little change in the risks or processes, management's daily involvement with the business may provide it with adequate knowledge to appropriately identify financial reporting risks.

Management's evaluation of financial reporting risks should also consider the vulnerability of the entity to fraudulent activity (*e.g.*, fraudulent financial reporting, misappropriation of assets and corruption) and whether any of those exposures could result in a material misstatement of the financial statements. Management should recognize that fraud risk exists in any organization, regardless of size or type, and may vary by location, segment or individual financial reporting element.

2. Identifying Controls that Adequately Address Financial Reporting Risks

Management should evaluate whether it has in place controls that are designed to adequately address the company's financial reporting risks. This determination involves judgments about both the likelihood and potential magnitude of misstatements arising from the financial reporting risk. A control consists of a specific set of policies, procedures and activities designed to meet the objective of accurate financial reporting, and it can be automated or manual and can include reconciliations, segregation of duties, review and approval authorizations, safeguarding, fraud detection or disclosure.

Management may identify preventive controls, which have the objective of preventing errors or fraud, or detective controls, which have the objective of identifying errors or frauds that have already occurred. While there may be more than one control that addresses the financial reporting risks for a financial reporting element, conversely, one control might address the risks of

more than one financial reporting element. Once a control is identified as adequately identifying or addressing a particular risk, in the interest of efficiency, management need not identify additional controls related to that risk.

Management may also consider the efficiency with which evidence of the operation of a control can be evaluated when identifying the controls that adequately address the financial reporting risks. When more than one control exists and each adequately addresses a financial reporting risk, management may decide to select the control for which evidence of operating effectiveness can be obtained more efficiently.

In addition to identifying controls that address the financial reporting risks of individual financial reporting elements, management also is to evaluate whether it has controls in place to address the entity-level and other pervasive elements of ICFR that its chosen control framework prescribes as necessary for an effective system of internal control. Examples of such controls include controls related to the control environment, controls over management override, the entity-level risk assessment process and monitoring activities, controls over the period-end financial reporting process and the policies that address significant business control and risk management practices.

3. Consideration of Entity-level Controls

Management should consider entity-level controls when identifying financial reporting risks and related controls for a financial reporting element.⁸ Some entity-level controls have an important, but indirect, effect on the likelihood that a misstatement will be prevented or detected on a timely basis (*e.g.*, controls that affect other controls that address financial reporting risks for a financial reporting element). Other entity-level controls may be designed to identify possible breakdowns in lower-level controls, but not in a manner that would, by themselves, adequately address financial reporting risks. Finally, some entity-level controls are designed to operate at the process, transaction, application or account level and on their own might adequately prevent or detect possible misstatements on a timely basis.

4. Role of General Information Technology Controls

The identification of risks and controls within IT (for example, failure to consistently apply a formula or perform a calculation) should not be a separate evaluation but should be an integral part of management's top-down, risk-based approach to identifying risks and controls and in determining evidential matter necessary to support the assessment. Controls may be automated, depend on IT functionality or require a combination of both and that IT general controls alone, without consideration of application controls, ordinarily do not adequately address financial reporting risks. Aspects of general IT controls that may be relevant to the evaluation of ICFR will vary depending upon a company's facts and circumstances. It is unnecessary to evaluate IT general controls that primarily pertain to efficiency or effectiveness but which are not relevant to addressing financial reporting risks.

5. Evidential Matter to Support the Assessment

⁸ It is important to consider the nature of the relationship of the control to the financial reporting element, that is, whether it is direct or indirect. The more indirect the relationship to a financial reporting element, the less effective a control may be in preventing or detecting a misstatement and the more unlikely that management will identify only this type of entity-level control to adequately identify the risk of a misstatement.

As part of its evaluation of ICFR, management must maintain reasonable support for its assessment. Documentation of the design of the controls placed in operation to adequately address financial reporting risk is an integral part of this reasonable support. The form and extent of the evidence will vary depending on the size, nature and complexity of the company. Evidence can take many forms, including paper documents, electronic or other media and can be presented in a number of ways, including policy manuals, process models, flow charts, job descriptions, internal memoranda or forms.

B. Evaluating Evidence of the Operating Effectiveness of ICFR

Management should evaluate evidence of the effective operation of ICFR. A control is operating effectively if it is operating as designed and the person performing the control possesses the necessary authority and competence to perform the control effectively. The evaluation procedures that management uses to gather evidence about the effective operation of controls should be tailored to its assessment of the risk characteristics of both the individual financial reporting elements and the related controls (collectively, “ICFR risk”). Management should ordinarily focus its evaluation of the operation of controls on those areas of ICFR that pose the highest ICFR risk. Management’s assessment of ICFR risk should also consider the impact of entity-level controls. Evidence about the effective operation of controls may be obtained from direct testing of controls and on-going monitoring activities.

In determining whether the evidence obtained is sufficient to provide a reasonable basis for its evaluation of the operation of ICFR, management should consider not only the quantity of evidence (*e.g.*, sample size) but also qualitative characteristics of the evidence (*e.g.*, the nature of the evaluation procedures performed or the objectivity of those evaluating the controls), and for any individual control, different combinations of the nature, timing and extent of evaluation procedures may provide sufficient evidence.

1. Determining the Evidence Needed to Support the Assessment

Management should evaluate the ICFR risk of the controls identified by it as adequately addressing the financial reporting risks for financial reporting elements to determine the evidence needed to support the assessment. Management’s consideration of the misstatement risk of a financial reporting element should include a consideration of 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. Entity-level controls should be considered and may influence management’s determination of the evidence needed to support its assessment of ICFR.

Management also should consider the likelihood that a control might fail to operate effectively.⁹ When a combination of controls is required to adequately address the risks of a financial reporting element, management should analyze the risk characteristics of each control.

⁹ That likelihood may depend on, among other things, (i) the type of control (that is, manual or automated) and the frequency with which it operates; (ii) the complexity of the control; (iii) the risk of management override; (iv) the judgment required to operate the control; (v) the competence of the personnel who perform the control or monitor its performance; (vi) whether there have been changes in key personnel who either perform the control or monitor its performance; (vii) the nature and materiality of misstatements that the control is intended to prevent or detect; (viii) the degree to which the control relies on the effectiveness of other controls (for example, general IT controls); and (ix) the evidence of the operation of the control from prior year(s).

Certain financial reporting elements, such as those involving related party transactions, critical accounting policies or related critical accounting estimates, generally would be assessed as having higher misstatement risk. Further, where controls related to these financial reporting elements are subject to the risk of management override, involve significant judgment or are complex, they should generally be assessed as having higher ICFR risk.

2. Implementing Procedures to Evaluate Evidence of the Operation of ICFR

Management should evaluate the evidence it gathers in order to determine whether the operation of a control is effective.

The methods and procedures management uses to gather evidence about the effective operation of controls, including the timing of when they are performed, are a function of the evidence that management considers necessary to provide reasonable support for its assessment of ICFR based on the assessment of ICFR risk. The evidence may come from a combination of on-going monitoring and direct testing of controls performed periodically to provide evidence about the reliability of such on-going monitoring activities.

Direct tests of controls are tests ordinarily performed on a periodic basis by individuals with a high degree of objectivity relative to the controls being tested. On-going monitoring includes management's normal, recurring activities that provide information about the operation of controls and may include self-assessment. As the ICFR risk increases, management should ordinarily adjust the nature of the evidence that is obtained. Management may utilize personnel who are more objective, or adjust the period of time covered by testing. When on-going monitoring activities are performed by personnel without adequate objectivity, management would ordinarily supplement the evidence obtained through that monitoring with evidence obtained by direct testing by objective persons. Where ICFR risk is low, management may be able to conclude that evidence from on-going monitoring is sufficient.

In smaller companies, management's daily interaction with its controls may provide it with sufficient knowledge about their operation to evaluate the operation of ICFR, but management should consider its particular facts and circumstances when determining whether or not such daily interaction with controls provides sufficient evidence for the evaluation. Daily interaction in companies with multiple management reporting layers or operating segments would generally not provide sufficient evidence because those responsible for assessing the effectiveness of ICFR ordinarily would not be sufficiently knowledgeable about the operation of the controls. In these situations, management would ordinarily use direct testing or on-going monitoring-type evaluation procedures to obtain reasonable support for the assessment.

Management's evaluation of evidence should consider whether the control operated as designed, how the control was applied, the consistency with which it was applied and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

3. Evidential Matter to Support the Assessment

The SEC would expect reasonable support for an assessment to include the basis for management's assessment, including documentation of the methods and procedures it utilizes to gather and evaluate evidence.

The evidential matter may take many forms and will vary depending on the assessed level of risk for controls over each of its financial reporting elements. For example, management may

document its overall strategy in a comprehensive memorandum that establishes the evaluation approach, the evaluation procedures, and the basis for conclusions for each financial reporting element. Documentation might include memoranda, e-mails, and instructions or directions from management to company employees. Evidential matter is not required to be separately maintained if evidential matter within the company's books and records is sufficient to provide reasonable support; however, the degree of complexity of the control, the level of judgment required to operate the control and the risk of misstatement could cause management to nevertheless determine to separately maintain the evidence.

C. Multiple Location Considerations

Management's consideration of financial reporting risks should generally include all of its locations or business units, though in some cases risks are adequately addressed by controls that operate centrally. When performing its evaluation of risk characteristics of controls identified, management should evaluate each location with respect to each of its financial reporting elements (rather than making a single judgment for all controls at the location) and consider location-specific risks that might impact the risk that a control will fail to operate effectively.

Reporting Considerations

A. Evaluation of Control Deficiencies

In order to determine whether a control deficiency, or combination of control deficiencies, is a material weakness, management should evaluate the severity of each control deficiency that comes to its attention. Multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and many, in combination, constitute a material weakness if there is a reasonable possibility that a material misstatement to the financial statements would not be prevented or detected in a timely manner, even though such deficiencies may be individually less severe than a material weakness. Therefore, management should evaluate individual control deficiencies that affect the same account balance, disclosure, relevant assertion, or component of internal control, to determine whether they collectively result in a material weakness. Management should also evaluate the effect of compensating controls when determining whether a control deficiency or combination of deficiencies is a material weakness.

The evaluation of the severity of a control deficiency should include both quantitative and qualitative factors. When evaluating the severity of a deficiency, or combination of deficiencies, in ICFR, management also should determine the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP. If management determines that the deficiency, or combination of deficiencies, might prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP, then management should treat the deficiency, or combination of deficiencies, as an indicator of a material weakness.

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

- the nature of the financial reporting elements involved (*e.g.*, suspense accounts and related party transactions involve greater risk);

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

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

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

In determining whether a deficiency or a combination of deficiencies represents a material weakness, management should consider all relevant information. Management should evaluate whether the following situations are “indicators”¹⁰ of the existence of a deficiency in ICFR and, if so, whether such a deficiency represents a material weakness:

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

B. Expression of Assessment of Effectiveness of ICFR by Management and the Registered Public Accounting Firm

Management should clearly disclose its assessment related to the effectiveness of ICFR and, therefore, should not qualify its assessment by stating that the company's ICFR is effective subject to certain qualifications or exceptions. In addition, if a material weakness exists,

¹⁰ The proposing release had specified a number of “strong indicators” that would mandate a finding of a material weakness. The SEC explicitly did not adopt that approach.

management may not state that controls are effective. Management may state, however, that controls are ineffective for specific reasons. If management's evaluation identifies material weaknesses, but all material weaknesses are remediated by the end of the fiscal year, management may conclude the ICFR is effective as of the end of the fiscal year. However, management should consider whether disclosure of such remediated material weaknesses would be appropriate or required under Item 307 or 308 of Regulation S-K.

Management may disclose any remediation efforts to the identified material weakness(es) in Item 9A of Form 10-K, Item 15 of Form 20-F, or General Instruction B of Form 40-F.

C. Disclosures About Material Weaknesses

Because of the significance of the disclosure requirements surrounding material weaknesses beyond specifically stating that the material weaknesses exist, companies should also consider including the following in their disclosures:¹¹

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

While management is required to conclude and state in its report that ICFR is ineffective when there are one or more material weaknesses, companies should also consider providing disclosure that allows investors to understand the root cause of the control deficiency and to assess the potential impact of each particular material weakness. This disclosure will be more useful to investors if management differentiates the potential impact and importance to the financial statements of the identified material weaknesses, including distinguishing those material weaknesses that may have a pervasive impact on ICFR from those material weaknesses that do not. The goal underlying all disclosure in this area is to provide investors with contextual disclosure and analysis which goes beyond the mere existence of a material weakness.

D. Impact of a Restatement of Previously Issued Financial Statements on Management's Report on ICFR

The restatement of financial statements does not, by itself, necessitate that management consider the effect of the restatement on the company's prior conclusion relating to the effectiveness of ICFR.

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

¹¹ Significant deficiencies in ICFR are not required to be disclosed in management's annual report on its evaluation of ICFR required by S-K Item 308(a).

Similarly, while there is no requirement that management reassess or revise its conclusion related to the effectiveness of its disclosure controls and procedures, management should consider whether its original disclosures regarding effectiveness of disclosure controls and procedures need to be modified or supplemented to include any other material information that is necessary for such disclosures not to be misleading.

E. Inability to Assess Certain Aspects of ICFR

In certain circumstances, management may encounter difficulty in assessing certain aspects of its ICFR. For example, management may outsource a significant process to a service organization and determine that evidence of the operating effectiveness of the controls over that process is necessary. However, the service organizations may be unwilling to provide either a Type 2 SAS 70 report or to provide management access to the controls in place at the service organization so that management could assess effectiveness. Finally, management may not have compensating controls in place that allow a determination of the effectiveness of the controls over the process in an alternative manner.

The SEC's disclosure requirements state that management's annual report on ICFR must include a statement as to whether or not ICFR is effective and do not permit management to issue a report on ICFR with a scope limitation. Therefore, management must determine whether the inability to assess controls over a particular process is significant enough to conclude in its report that ICFR is not effective.

* * * *

This memorandum highlights elements of the rule amendments and the interpretive guidance relating to ICFR. This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Moreover, we are not accountants and do not purport to be interpreting any accounting statements. Questions concerning this memorandum should be directed to any member of the Paul Weiss Securities Group, including:

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Annex ACertain Amendments to the Proposed Guidance

1. *Alignment with AS 5.* The adopted guidance was revised to align it, in a number of respects, with AS 5. For example, the material weakness definition and the related guidance for evaluating ICFR deficiencies, guidance for evaluating whether controls adequately address financial reporting risks, the factors to consider when identifying financial reporting risks and the factors for assessing the risk associated with individual financial reporting elements and controls were revised. Nevertheless, certain differences will remain, which will primarily stem from the differences in the roles, responsibilities and perspectives of management and the external auditors.
2. *Identification of Fraud Risks and Related Controls.* In this area, the proposal was modified by the SEC to clarify that fraud risks are expected to exist at every company and that the nature and extent of the fraud risk assessment activities should be commensurate with the size and complexity of the company. The SEC also added some references to additional existing guidance in this area.
3. *Entity-Level Controls.* The adopted guidance modified the proposed guidance by expanding the discussion of entity-level controls. The adopted guidance also clarifies that the controls identified by management should include entity-level and pervasive elements of its ICFR that are necessary to provide reasonable assurance.
4. *IT General Controls.* The adopted guidance clarified the proposed guidance by explaining that the identification of risks and controls within IT should be integral to, and not separate from, management's evaluation and evidentiary process. The SEC also clarified that controls may be automated, depend on IT functionality or require a combination of both and that IT general controls alone, without consideration of application controls, ordinarily do not adequately address financial reporting risks. The SEC also clarified that it is unnecessary to evaluate IT general controls that primarily pertain to efficiency or effectiveness but which are not relevant to addressing financial reporting risks.
5. *Evaluating Evidence.* The adopted guidance clarifies that management's experience with a control's operation both during the year and as part of its prior year assessments may influence its decisions regarding the risk that controls will fail to operate as designed, which may have an effect on the evidence needed to support management's conclusions with respect to the effectiveness of the operation of the control as of the date of management's assessment.
6. *Nature of On-Going Monitoring Activities.* The adopted guidance clarifies that on-going monitoring, including self-assessments, may be done by various individuals with varying degrees of objectivity. Such variations necessarily affect the sufficiency of the evidence obtained from on-going monitoring activities. The varying degrees of objectivity of company personnel performing such monitoring activities should also be taken into account in determining whether the evidence generated by such activities constitutes sufficient evidence of an internal control's effectiveness.
7. *Strong Indicators of a Material Weakness.* The adopted guidance modified the proposed guidance to emphasize that the evaluation of control deficiencies requires the consideration of all relevant facts and circumstances. Therefore, the adopted guidance does not refer to "strong indicators" that mandate a finding of a material weakness but rather lists a number of "indicators" that should be considered in determining whether a material weakness exists. The list is not meant to be exhaustive.

8. *Disclosure of Material Weaknesses.* The proposed guidance would have permitted management to state that ICFR was “ineffective due solely to, and only to the extent of” identified material weaknesses. The adopted guidance does not permit such a statement to be made but rather only permits management to state that ICFR was not effective due to the specific reasons.