



# Issues Related to the Assessment of the Effectiveness of Management Review Controls: Roundtable Summary

April 2021

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financial education &  
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# Introduction

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The Center for Audit Quality and the Financial Education & Research Foundation (FERF) of Financial Executives International (FEI) commissioned John Fogarty, Mark Beasley and Doug Prawitt to conduct an independent qualitative research study on Internal Control over Financial Reporting (ICFR) management review controls (MRCs), *Perspectives on Management Review Controls: Challenges and Solutions* (the Research Report). The research focused on subjective, judgment-based MRCs. Through a series of detailed, semi-structured interviews with preparers – in particular the control owners and control performers – the researchers gathered perspectives on how management determines what constitutes effective design, precision, implementation, execution and documentation of MRCs. The research team also separately interviewed the participating companies' auditors to get their perspectives on the MRCs that were discussed with the preparers.

Areas of MRCs that involve subjective judgments create challenges. Documenting and evaluating judgments made and decision processes used by those performing the underlying control activities are inherently difficult tasks for both management

Preparers consistently cited several benefits stemming from their efforts to comply with Section 404(a) of the Sarbanes-Oxley Act of 2002 (SOX).

and the auditor in their assessments of the design and operating effectiveness of the controls. The objective of the research was to identify and understand areas of difficulty or particular complexity in management's design, performance, and documentation of MRCs, as well as to identify effective practices in dealing with these areas.

The Research Report highlights several consistent themes arising from the interviews. Preparers consistently cited several benefits stemming from their efforts to comply with Section 404(a) of the Sarbanes-Oxley Act of 2002 (SOX), including that it improved management's focus on internal controls and financial reporting overall. SOX compliance

also led to better integration of internal controls into business processes. However, preparers cited some concerns about what they perceived to be a diminished emphasis on the principles-based guidance issued by COSO in its *2013 COSO Internal Control - Integrated Framework*, the Securities and Exchange Commission guidance for preparers, and PCAOB standards for auditors. There was a consensus among many of the preparers who were interviewed that there are constant increases in the expected level of documentation related to MRCs. For additional details on the methodology, key findings and suggested actions based on the interviews with preparers and their auditor, the reader is encouraged to refer to the [Research Report](#).

## WHAT IS A MANAGEMENT REVIEW CONTROL?

Management is responsible for preparing reliable financial information. Its ability to fulfill its financial reporting responsibilities depends in part on the design and operating effectiveness of the controls and safeguards it has put in place over accounting and financial reporting. A system of ICFR is designed to address risks and provide reasonable assurance that the company's financial statements are reliable and prepared in accordance with generally accepted accounting principles (GAAP).

Many important accounting measurements are inherently imprecise and based on subjective judgments about what the preparer and reviewer believe to be the best information available at the time. The internal controls over these types of accounting measurements are referred to as

management review controls, or MRCs. MRCs usually involve a string of activities, each of which in turn may be associated with lower-level control activities, including controls that address the completeness and accuracy of the underlying information, which often may come from disparate internal and external sources. Subjective judgments create challenges both for the control performers and for auditors. Common examples of MRCs include the following:

- + Budget-to-actual comparisons
- + Period-over-period comparisons
- + Reviews of estimates for reasonableness, including estimates of fair value and reviews of potential impairments

# Highlights from the round table discussions

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Following the release of the Research Report, the CAQ and FERF hosted a virtual roundtable on December 14, 2020 to obtain perspectives of preparers and auditors who did not participate in the research study. CAQ and FEI wanted to further explore areas that continue to create challenges in implementing effective design, precision, and operation of MRCs and the related documentary evidence issues associated with assessing their effectiveness. The primary objective of the virtual roundtable was to identify and share leading practices that can mitigate the challenges that preparers and auditors have in addressing these often highly subjective controls. In addition to the researchers who conducted the research, the roundtable included preparers from a variety of industries and included chief accounting officers, controllers, and MRC owners. Engagement partners with recent MRC audit experience in various industries and audit methodology leaders from the CAQ's Governing Board firms also participated in the roundtable. Representatives from the CAQ and FEI staff were in attendance as well.

The roundtable kicked off with a panel discussion that highlighted the key findings from the Research

## **WHAT WE HEARD: KEY BEST PRACTICES TO ADDRESS MRC CHALLENGES**

- + A well-documented risk-assessment by management with respect to the importance of its MRCs to its system of internal controls may help to align the auditor's risk assessment with management's views.
- + Auditors can directly observe MRCs to reduce the documentation requests made by the auditor.
- + Holding detailed walkthrough meetings for management and the auditor allows the parties to align on expectations before the auditor commences testing of the MRCs.
- + Management, and the auditor, should each perform a risk assessment of the underlying data to determine which of its elements are the most critical to the operation of the MRC.

Report. This helped to lay the groundwork for smaller group discussions.

The participants were split into three breakout groups of 8 – 10 attendees comprised of a mix of preparers and auditors. Each group discussed the issues and challenges associated with the design and precision of MRCs, the operation and performance of MRCs, and planning and communication of the assessment of effectiveness of MRCs. Each of the breakout sessions was moderated by a member of the research team. An overarching theme that emerged from the breakout discussions is that the MRC challenges highlighted in the Research Report stemming from interviews conducted in 2018-2019 continue to be compellingly relevant today, given the inherently subjective nature of MRCs, among other factors. Many preparers also stated they believe that over the past three years the level of documentation to support the design and operation of MRCs has continued to increase. The following summary highlights the key takeaways from the breakout discussions. The highlights do not necessarily represent the views of any specific individual, entity, firm, CAQ Governing Board member, or FEI member.

### **PLANNING AND COMMUNICATION OF ASSESSMENT OF EFFECTIVENESS OF MRCs**

The value of a well-documented risk assessment by management with respect to the importance of its MRCs to its system of internal controls was one of the most consistent themes that was raised by preparers and auditors in the breakout discussions. Multiple preparers noted that a risk assessment that documents which MRCs management believes address the highest risk elements of a particular financial statement account and why can help to align the auditor's risk assessment with that of management's views, to the extent possible. Such alignment can help to mitigate some of the potential friction that may arise when management believes that auditors are requesting additional documentation for what management believes are MRCs that address lower risk elements of a financial statement account, or when management does not believe the auditor is focused on the MRCs that they believe address greater financial reporting risks.

Another theme that was consistently mentioned in the breakout sessions as a best practice to mitigate

the challenges outlined in the Research Report was for the auditor to hold detailed walkthrough meetings with management. This practice was especially evident among the participants when discussing new MRCs. Preparers highlighted the value of them coming together with their auditor in a walkthrough-type meeting early in the audit cycle. At this meeting, the parties would discuss a specific process, the MRCs within that process, which control activities and attributes management and the auditor believe are more subjective, expectations as to the level of precision of the control, and what evidence could be made available to support each of the control attributes. Participants generally believed that detailed walkthrough meetings for management and the auditor to align on expectations before the auditor commences testing of the MRCs helps to mitigate some of the challenges commonly cited by participants, as outlined in the Research Report.

### **DESIGN AND PRECISION OF MRCs**

Several participants expressed their belief that, due to their nature, most MRCs are critical to operating the business and it should be rare that MRCs are designed solely to satisfy the SOX ICFR requirements. An example discussed by an auditor that illustrated this alignment was an MRC related to a cash flow analysis performed by management to assess how much they should pay to acquire another entity. Elements of such analyses would often also represent a downstream MRC related to the accounting for the business combination. The discussion reinforced the suggested action for preparers in the Research Report that designing internal controls that generate multiple benefits was a best practice for mitigating some of the challenges related to MRCs.

Many participants discussed the importance of management documenting a risk assessment relating to each complex MRC when designing the MRCs. Performing a risk assessment helps identify underlying risks and clarifies which attributes, or elements, of the MRC that management believes are most critical at preventing or detecting a potential material misstatement. An example that was discussed by one preparer was an MRC related to the review of prospective financial information (PFI) that has several inputs and assumptions, but only 2-3 assumptions that could potentially result in a material misstatement in the resulting



valuation. The preparer noted that management's documentation of the risk assessment of the inputs and assumptions used in an MRC, such as the PFI example, helps management know where to focus their own review and simultaneously demonstrates for the auditor that a thoughtful risk assessment occurred. Another preparer shared that absent such a risk assessment of complex MRCs, the auditor may believe that more assumptions and/or inputs are critical than does management, potentially resulting in an expectation gap between preparers and auditors.

The risk assessment exercise should extend to evaluating the data that are used in the MRC. Multiple preparers and auditors in the breakout sessions shared the view that it is important for management to understand the lineage of the data used in MRCs, e.g., how the MRC owner gets comfortable that the data being used in the review are reliable. Many participants suggested that it is best practice that management, and the auditor, perform a risk assessment relating to the underlying data to determine which elements of the data are the most critical to the operation of the MRC. The documentation should focus the evidence of the data's reliability (e.g., its completeness and accuracy) for those key elements. One participant believed that this should be viewed as a scale: the design of the controls and the extent of documentation to assess the reliability of the underlying data used in MRCs should be determined by the importance of the underlying data to the overall MRC, its objectives, and the sensitivity of the data inputs to the MRC's ability to prevent or detect a potential material misstatement.

## OPERATION AND PERFORMANCE OF MRCs

Preparers in the breakout groups discussed the documentation to evidence the performance of an MRC and how helpful that documentation is to the operation of the business. Consistent with the themes summarized in the Research Report, many preparers in the breakout groups believe the documentation of the operation and performance of most MRCs helps management support its assessment of internal control as well as run the business. One preparer noted that there is an additional benefit to be derived: strong documentation of the operation and performance of MRCs also assists with training new control

### Suggested Actions to Address Challenges with the Management's Assessment and Auditor's Evaluation of the Effectiveness of MRCs

Based on the series of interviews conducted in 2018 and 2019 for the research study, several key actions were suggested for preparers and auditors.

#### Key Actions for Preparers:

- + Set the right tone regarding the importance of internal control
- + Create and maintain infrastructure to support SOX compliance
- + Design internal controls that generate multiple benefits
- + Increase focus and attention on highly subjective judgments
- + Focus on underlying assumptions
- + Establish timelines for control performance
- + Consider the nature and extent of documentation of the MRC review
- + Foster open and regular dialogue with external auditors
- + Invite auditors to observe management meetings

#### Key Actions for Auditors

- + Be clear about expectations at the outset
- + Communicate clearly and timely
- + Reconsider the extent of documentation needed based on risk
- + Assign appropriately experienced personnel
- + Rethink the approach to the control environment
- + Minimize disruptions in managing audit team personnel rotations/changes
- + Minimize disruptions when changing policies and methodologies

Source: Fogarty, John, Mark Beasley, Doug Prawitt. *Perspectives on Management Review Controls: Challenges and Solutions, Insights from a Qualitative Study of the Issues*. Center for Audit Quality and Financial Education & Research Foundation. November 2020.



owners when new employees are hired, or existing employees rotate into a new role.

Another theme that emerged from the discussions was the idea of allowing the auditor to observe key meetings where management engages in discussions and makes decisions that serve as primary evidence of a given MRC's performance. This was also a suggested action for preparers that was included in the Research Report as a leading practice based on the extensive interviews conducted during the study. These meetings provide an opportunity for the auditor to evidence the operation and performance of complex MRCs, when key assumptions that underlie

an MRC are discussed, or when a business judgment is made that is an important input to the MRC. Auditors in the breakout sessions consistently cited this as an effective testing technique with respect to obtaining evidence of the effective operation and performance of complex MRCs. One auditor noted that allowing auditors to observe such meetings can help to eliminate some of the back and forth between the preparer and the auditor, as the auditor can observe firsthand the level of precision at which the MRC is operating. Another auditor noted that oftentimes allowing the auditor to observe key MRC meetings can assist in reducing the documentation requests made by the auditor. •

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