

# **SEC AMENDS RULES REGARDING MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

The SEC has amended its rules relating to the evaluation of internal control over financial reporting ("ICFR"). Under the amendments:

- a management evaluation of ICFR conducted in accordance with the SEC's new Interpretive Guidance in Release No. 34-55929 (summarized in Annex A) is one (though not the exclusive) manner of satisfying the evaluation requirements in Exchange Act Rules 13a-15(c) and 15d-15(c).
- an auditor is required by Rule 2-02(f) of Regulation S-X to express an opinion directly on the effectiveness of an issuer's ICFR, rather than only as to whether management's evaluation was fairly stated.
- a "material weakness" is defined 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."
- a "significant deficiency" is 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."

The rule changes and the Interpretive Guidance are intended to assist management and auditors to complete their annual evaluation of ICFR in an effective and efficient manner.

The amendments with respect to the first three items become effective on August 27, 2007. The amendments relating to the definition of "significant deficiency" become effective on September 10, 2007.

In addition, at an open meeting on July 25, 2007, the SEC approved the PCAOB's Auditing Standard No. 5 effective for audits of ICFR for fiscal years ending on or after November 15, 2007. The new standard is designed to result in a more efficient audit of ICFR in conjunction with the rule changes and Interpretative Guidance.

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### **Exchange Act Rules 13a-15(c) and 15d-15(c)**

- Exchange Act Rules 13a-15(c) and 15d-15(c) require the management of each issuer to evaluate the effectiveness of its ICFR as of the end of each fiscal year.
- These rules are being amended to provide that, although there are many different ways to conduct an evaluation of the effectiveness of ICFR, an evaluation conducted in accordance with the Interpretive Guidance in Release No. 34-55929 (summarized in Annex A) would satisfy the evaluation requirement in those rules.
- Compliance with the Interpretive Guidance is voluntary. Companies are not required to alter their existing procedures to align them with the Interpretive Guidance.

### **Rules 1-02 and 2-02 of Regulation S-X and Item 308 of Regulations S-B and S-K**

- Under current Rule 2-02(f) of Regulation S-X the issuer's auditor is required to express an opinion as to whether management's assessment of the effectiveness of the issuer's ICFR is fairly stated in all material respects.
- Rule 2-02(f) of Regulation S-X is being amended (together with a conforming amendment to Rule 1-02(a)(2)) to require the auditor to express a single opinion directly on the effectiveness of ICFR in its attestation report.
  - The SEC noted:
    - the auditor's opinion necessarily conveys whether the disclosure of management's assessment is fairly stated;
    - the expression of a single opinion directly on the effectiveness of ICFR clarifies that an auditor is not responsible for issuing an opinion on management's process for evaluating ICFR; and
    - an auditor is required under applicable auditing standards to evaluate whether management has included in its annual assessment report all of the disclosures required by Item 308 of Regulations S-B and S-K and to modify its audit report on the effectiveness of ICFR if it determines that management's assessment of ICFR is not fairly stated.
- The amended rules refer to the auditor's report as an "attestation report on internal control over financial reporting" rather than an "attestation report on management's assessment of internal control over financial reporting."

## Definition of Material Weakness

- A definition of "material weakness" has been added to Exchange Act Rule 12b-2 and Rule 1.02 of Regulation S-X:
  - The term material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting ...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 SEC rejected approaches that would have had the effect of increasing the risk that a material misstatement in a company's financial reports could occur before being disclosed as they could give rise to questions about the meaning of a disclosure that ICFR is effective and whether the threshold for "reasonable assurance" is being lowered.
- The definition refers to interim financial statements. Accordingly, management must disclose to investors any deficiency identified in its annual evaluation that poses a reasonable possibility of a material misstatement in the company's quarterly reports and not assess ICFR as effective.

## Significant Deficiency

- A definition of "significant deficiency" has been added to Exchange Act Rule 12b-2 and Rule 1.02 of Regulation S-X:
  - The term significant deficiency is 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 the registrant's financial reporting.
- The definition focuses on matters important enough to deserve discussion among management, audit committees and independent auditors.
- The definition does not include a likelihood component (unlike the definition of material weakness) to reduce the chance that management or independent auditors will design and implement ICFR evaluations or audits to detect anything less severe than a material weakness.
- Under SEC rules a company's principal executive officer and principal financial officer must certify that they have disclosed to the audit committee and the external auditor significant deficiencies in the design or operation of ICFR that are reasonably likely to adversely affect the company's ability to record, process, summarize and report financial information.

**SEC GUIDANCE REGARDING MANAGEMENT'S REPORT ON INTERNAL  
CONTROL OVER FINANCIAL REPORTING ("ICFR")  
[RELEASE NOS. 33-8810 AND 34-55929]**

**INTRODUCTION**

- Management is responsible for maintaining a system of ICFR that provides reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP (Exchange Act Rules 13a-15(c) and 15d-15(c)).
  - Management must conduct an annual evaluation of ICFR and disclose its assessment to investors.
  - Management must maintain evidential matter to provide reasonable support for its assessment.
- Compliance with the SEC's Interpretative Guidance is one way to satisfy the evaluation requirements in the SEC's rules.
- The SEC's Interpretative Guidance is not intended to replace the elements of an effective internal control system within the control framework selected by management to base its evaluation.

**TWO GENERAL PRINCIPLES**

- **FIRST PRINCIPLE**
  - 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.
    - Management is not required to evaluate and document all controls affecting ICFR.
    - Management should focus on controls it determines adequately address the risk of a material misstatement.

- **SECOND PRINCIPLE**

- Management's evaluation of evidence should be based on its assessment of risk.
  - Management should focus on those areas posing the greatest risk to reliable financial reporting and perform more extensive testing in those areas.
  - Management may use more efficient approaches such as self-assessment in low risk areas.

## **EVALUATION PROCESS**

- The purpose of the evaluation of ICFR is to provide management with a reasonable basis for its annual assessment whether there exists any material weakness in ICFR as of the end of the fiscal year.
  - The evaluation must be made in accordance with a suitable control framework's definition of effective internal control.
- **FIRST STEP**
  - Identify risks that could result in a material misstatement of the financial statements.
    - Methods to identify risk will vary depending on the company but usually the process begins with evaluating how the requirements of GAAP apply to the company.
    - SEC suggests management may find it useful to consider "what could go wrong" with a financial reporting element to identify the source, potential likelihood and materiality of misstatements in the financial statements.
- **SECOND STEP**
  - Determine whether the company's controls adequately address the company's financial reporting risks.
    - The risks include all of the company's locations and units:
      - The financial reporting risks may be addressed by controls that operate centrally where management determines that ICFR risk of controls that operate at individual locations or

business units is low and sufficient evidence can be gathered through self-assessment routines in combination with the evidence derived from a centralized control.

➤ Where the risk of failure of controls at individual locations is high more evidence is required concerning the controls at the location.

▪ Management should consider the risk characteristics of the controls for each financial reporting element rather than forming a single judgment for all controls at the location.

- **THIRD STEP**

- Document the design of the controls management has placed in operation.

- The form and extent of the documentation will vary depending on the company.

- The documentation may be presented in a number of ways (for example, policy manuals, flow charts, memoranda etc) but should focus on those controls that are adequate to address the financial reporting risks.

- **FOURTH STEP**

- Evaluate evidence of operating effectiveness.

- Management should focus its evaluation on areas with the greatest ICFR risk. Management should consider, among other factors, the extent to which a financial element involves judgment in determining recorded amounts, is susceptible to fraud or has complex accounting requirements.

- Management should assess:

- Type of control.

- Complexity of the control.

- Risk of management override.

- Judgment required for the operation of the control.

- Competence of personnel and changes in personnel who operate the control or monitor its performance.

- Nature and materiality of misstatements that the control is intended to prevent or detect.
- Degree to which the control relies on the effectiveness of other controls (IT controls).
- Evidence from prior years.
- Financial reporting elements involving related party transactions, critical accounting policies and related critical accounting elements generally have a higher misstatement risk:
  - These elements, where subject to the risk of management override, involving significant judgment or complexity, should be assessed as having greater ICFR risk.
- Evidence comes from direct tests of controls, on-going monitoring, or a combination of both.
  - As ICFR risk increases, management should adjust the nature of the evidence that is obtained:
    - Increase evidence from on-going monitoring activities by more objective personnel, increase amount of testing through periodic direct testing or increase the period of direct testing;
    - If ICFR risk is high, evidence should consist of direct testing or on-going monitoring activities by persons with a higher degree of objectivity.
- In determining the effectiveness of a control management should consider whether the control operates as designed, how the control is applied, the consistency with which it is applied and whether the person performing the control has the necessary authority and competence to perform the control effectively.
- **FIFTH STEP**
  - Support management's assessment by evidential matter that provides reasonable support for its assessment.

- Include documentation of how management formed its conclusion about the effectiveness of entity-level controls and other elements necessary for an effective system of internal control under the framework selected by management to base its evaluation.
  - Management may document in a memorandum its evaluation approach and procedures and the basis for its conclusion about the effectiveness of controls.
  - Management should consider the degree of complexity of the control, the level of judgment required to operate the control, and the risk of misstatement in the financial reporting element that could result in a material misstatement of the financial statements.
    - As these factors increase, management may determine that the evidentiary matter should be separately maintained.

## **CONTROL DEFICIENCIES**

- Management must evaluate the severity of each control deficiency and disclose in its annual assessment of effectiveness of ICFR any deficiencies that are material weaknesses.
  - Management should evaluate individual control deficiencies that affect the same financial statement amount or disclosure, or component of internal control, to determine whether they result in a material weakness.
  - The severity of a deficiency depends on whether there is a reasonable possibility that the company's ICFR will fail to prevent or detect a misstatement on a timely basis (not whether a misstatement has actually occurred).
- Factors that management should consider in evaluating whether there is a reasonable possibility that a deficiency will result in a misstatement include:
  - The nature of the financial reporting elements.
  - The susceptibility of the related asset or liability to loss or fraud.
  - The subjectivity, complexity, or extent of judgment required to determine the amount involved.
  - The interaction of the control with other controls.

- The interaction of the deficiencies.
- The possible future consequence of the deficiency.
- Factors that affect the magnitude of the misstatement that might result from a deficiency in ICFR include:
  - The financial statement amounts or total of transactions exposed to the deficiency.
  - 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.
- Management should evaluate whether the following situations indicate a deficiency in ICFR exists and, if so, whether it 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.
  - Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.

## **DISCLOSURES OF DEFICIENCIES**

- The severity of a deficiency should be evaluated under a prudent officials standard:
  - 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.

- If a material weakness exists, management may not state that ICFR is effective or that ICFR is effective subject to certain qualifications.
  - Management may state that ICFR is ineffective for specific reasons.
- In addition to stating that a material weakness exists, management should consider disclosing:
  - The nature of the material weakness.
  - Its impact on the issuer's financial reporting and ICFR.
  - Management's current plans to remediate the material weakness or any actions already taken.
  - Any factors that may be important to the assessment of the potential effect of any particular material weakness.