Financial Services and E-Commerce

Securities and Exchange Commission Issues Guidance on Management's Evaluation of Internal Control over Financial Reporting

*By Daniel Fisher**

The Securities and Exchange Commission (SEC) recently issued interpretative guidance ("Guidance") in connection with corporate management's evaluation of internal control over financial reporting ("ICFR"), which is required for under Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX 404") for companies required to file reports under the Securities and Exchange Act of 1934.[1] The Guidance is part of a combined effort by the SEC and the Public Company Accounting Oversight Board (PCAOB)—which recently adopted a new auditing standard relating to audits of ICFR—to address the growing criticism that the costs of compliance with SOX 404 far exceed the benefits.[2] The Guidance is intended to make the ICFR evaluation process more efficient and cost-effective, and is designed to apply to companies of varying sizes and complexities.

In related actions, the SEC amended its rules to clarify that a management evaluation of ICFR conducted in accordance with the Guidance is one (but not the only) way to satisfy management's obligation to conduct the evaluation. The SEC also simplified the auditor opinion required under SOX 404. Finally, the SEC adopted a definition of "material weakness" and proposed a definition of "significant deficiency," in each case intending to provide greater clarity on those terms.[3]

The Guidance and related rulemaking do not require companies that already comply with SOX 404 to change processes and procedures that are currently in place and with which management, audit committees and auditors are comfortable. The Guidance may, however, provide such companies with greater flexibility to streamline their evaluation processes going forward and to reduce the costs of SOX 404 compliance. In addition, the Guidance should be helpful to the significant number of "non-accelerated filers"—generally, those companies with a market capitalization below $75 million—which have not yet been required to comply with SOX 404 and are preparing to come into compliance later this year, as well as those companies that are not yet reporting companies but may become reporting companies in the future.[4]

The Guidance — Principles

The Guidance is organized around two broad principles. The first is that management should evaluate whether it has implemented controls that adequately address the risks of failing to prevent, or not detecting in a timely manner, a material misstatement in the company's financial statements. The Guidance sets forth a top-down, risk-based approach to this principle. This approach contrasts with the practice of many companies that have attempted to identify and evaluate every possible control, regardless of the risk that a failure of that control would result in a material misstatement. And second, that management's evaluation of its controls should be based on its assessment of risk. This principle attempts to address concerns about rigid approaches to the level of documentation needed to substantiate management's evaluation of ICFR.

The Guidance — The Evaluation Process

As stated in the existing SEC rules implementing SOX 404, the objective of ICFR is to provide reasonable assurance regarding the reliability of financial reporting and regarding the preparation of financial statements for external purposes in accordance with GAAP. Those rules require that annual reports contain management's assessment of the effectiveness of ICFR; the purpose of the management-evaluation requirement in those rules is to provide management with a reasonable basis for that assessment. The Guidance describes the evaluation process as having two parts: first, management identifies risks to reliable financial reporting and the controls that address those risks (including evaluating whether the controls are designed to adequately address the identified risks); and second, management evaluates the operation of those controls to determine their effectiveness.

As described in the Guidance, the starting point is for management to consider "what could go wrong" with respect to a financial statement amount or related disclosure, in order to identify the sources and potential likelihood of misstatements and the risks that could result in a material misstatement in the financial statements. This risk-identification process should incorporate management's knowledge of the company's business and operations, including the vulnerability of the business to fraudulent activity. The size, complexity, and organizational structure of the company and its processes should be a factor in management's risk evaluation.

The Guidance describes the next step in the process as involving management's judgments about whether the controls in existence, if operating properly, can effectively prevent or detect misstatements that could result in material misstatements in the company's financial statements. The Guidance emphasizes that it is not necessary to identify all controls that may exist, and that, in a situation where multiple controls address the same risk, management may decide to focus its evaluation on the control for which evidence of operating effectiveness can be obtained more efficiently. For example, it may be more efficient to evaluate automated controls rather than manual controls where both address the same risk.

In addressing the process for evaluating evidence of the operating effectiveness of a control, the Guidance indicates that management should consider whether the control is operating as designed and whether the person performing the

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control possesses the necessary authority and competence to perform the control effectively. The focus of this evaluation should be on those areas posing the highest risk to ICFR—and, to this end, factors that should be taken into account in determining risk include whether a particular financial statement amount or disclosure involves judgment in determining the recorded amounts, is susceptible to fraud, has complex accounting requirements, experiences change in the nature or volume of the underlying transactions, or is sensitive to changes in environmental factors such as economic developments. The Guidance states that the amount of evidence needed to support management's assessment of the effectiveness of ICFR—which assessment considers both the quantity and quality of the evidence—is a function of the materiality of the financial statement amount or disclosure in question and the susceptibility to material misstatement of the underlying account balances, transactions, or supporting information to material misstatement. The Guidance provides further clarification by stating that evaluation methods may be integrated with daily responsibilities or may be performed for other management reasons, and need not be limited to procedures implemented specifically for the ICFR evaluation.

The Guidance — Reporting Considerations

Under the SEC rules implementing SOX 404, management may not conclude that ICFR is effective if there are one or more "material weaknesses" as of the fiscal year end, and any such material weakness must be disclosed as part of management's report. The Guidance makes clear that, as part of management's evaluation, management must consider whether each deficiency, alone or in combination with other deficiencies, constitutes a material weakness, and that this evaluation involves both quantitative and qualitative factors. The Guidance sets forth a number of factors that could affect whether a deficiency, or a combination of deficiencies, will result in a misstatement of a financial-statement amount or disclosure. Among these factors are the nature of the financial reporting amounts or disclosures involved, the susceptibility of the asset or liability to loss or fraud, the complexity of any required judgment, interaction with other controls or deficiencies, and the possible future consequences of the deficiency. The Guidance also makes clear that the effect of compensating controls can be taken into account in determining whether a deficiency is a material weakness.

Current auditing standards list certain situations as "strong indicators" of a material weakness. As a practical matter, in most instances the presence of these factors has been viewed as mandating the conclusion that a material weakness exists. The Guidance departs from this position by emphasizing that whether a deficiency constitutes a material weakness is a matter of judgment based on all the relevant facts and circumstances. As a result, the Guidance calls for management to consider whether the following situations indicate a deficiency in ICFR and, if so, whether they represent a material weakness: fraud, whether or not material, by senior management; a restatement of financial statements to correct a material misstatement; detection of a material misstatement in current-period financial statements in circumstances that indicate the misstatement would not have been detected by ICFR; and ineffective oversight by the audit committee.

Consistent with prior, informal guidance by the SEC staff, the Guidance states that if a material weakness exists, companies should consider disclosing the nature of such weakness, its impact on the company's financial reporting and ICFR, and management's plans or ongoing actions to remedy the material weakness.

The Guidance also formalizes the SEC staff guidance that in the event of a restatement of previously issued financial statements management should consider whether the original disclosure—as to the effectiveness of ICFR and the effectiveness of disclosure controls and procedures for the period that is the subject of the restatement—is still accurate, and should amend those disclosures as necessary so as not to be misleading in light of the restatement.

Amendments to SEC Rules Implementing SOX 404

In connection with the Guidance, the SEC amended its rules implementing SOX 404 to make clear that a management evaluation of ICFR conducted in accordance with the Guidance will satisfy management's obligation under the rules. The amended rules also make clear that the Guidance is only one of many ways to conduct an evaluation of ICFR. Accordingly, there is no requirement for companies that are already SOX 404-compliant to alter their procedures to fit within the Guidance. In addition, the SEC amended its rules concerning the auditor's SOX 404 attestation. Instead of opining on whether management's assessment of the effectiveness of ICFR is fairly stated in all material respects, as well as whether ICFR is effective, auditors will opine only as to whether the company maintained effective ICFR.

Definitions of "Material Weakness" and "Significant Deficiency"

When first implementing SOX 404, the SEC referred to the definitions of "material weakness" and "significant deficiency" in the accounting literature in existence at that time and, later, as modified in PCAOB auditing standards. In connection with the Guidance, the SEC codified in its rules the definition of material weakness as "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."[5]

In connection with its consideration of the Guidance and related rule amendments, the SEC has also proposed to codify in its rules a definition of "significant deficiency." Unlike a material weakness, a significant deficiency does not render ICFR ineffective and, accordingly, identifying significant deficiencies is not part of the purpose of management's evaluation or of the auditor's attestation regarding ICFR. Significant deficiencies are relevant in that the CEO and CFO certifications required by Sarbanes-Oxley must indicate that the CEO and CFO have disclosed any significant deficiencies in ICFR (as well as any material weaknesses) to the auditor and to the audit committee. Consistent with the underlying theme

of communication among management, audit committees and auditors, the SEC has proposed to define a significant deficiency 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."[6]

Endnotes

1 The Guidance is *available at* http://www.sec.gov/rules/interp/2007/33-8810.pdf.

2 Following approval by the SEC, PCAOB Auditing Standard No. 5, An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements, *available at* http://www.pcaobus.org/Rules/Docket_021/2007-06-12_Release_No_2007-005A.pdf, would replace the current Auditing Standard No. 2.

3 The adopting release amending the rules and defining "material weakness" is *available at* http://wwww.sec.gov/rules/final/2007/33-8809.pdf. The release proposing a definition of "significant deficiency" is *available at* http://www.sec.gov/rules/proposed/2007/33-8811.pdf.

4 Non-accelerated filers must include management's report on ICFR in their annual reports for fiscal years ending on or after December 15, 2007, although the related auditor attestation is not required until annual reports for fiscal years ending on or after December 15, 2008. Newly public companies may avail themselves of a transition period allowing them to omit management's report on ICFR and the related auditor attestation from their first annual report.

5 *See supr*a note 3.

6 *Id*.