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Securities Alert

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SEC Issues Interpretive Guidance on Management's Assessment of Internal Control Over Financial Reporting and Related Rule Amendments and Approves New PCAOB Auditing Standard No. 5

On June 20, 2007, the Securities and Exchange Commission ("SEC") issued interpretive guidance (the "Guidance") on how management may conduct its annual evaluation of the effectiveness of internal control over financial reporting ("ICFR").[1] The Guidance is intended to make management's assessment of ICFR more efficient and cost-effective by providing issuers with a top-down, risk-based alternative that is approved by the SEC and that provides a "safe harbor" to comply with SEC rules implementing Section 404 of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act"). The Guidance was effective June 27, 2007.

Also, on June 20, 2007, the SEC issued amendments to the rules regarding management's report on the effectiveness of ICFR.[2] These amendments (i) add a definition of a "material weakness," (ii) require the independent auditor to issue a single opinion directly on the effectiveness of ICFR, while no longer requiring a separate opinion on management's assessment of effectiveness and (iii) integrate the "safe harbor" provided by the Guidance. These amendments are effective August 27, 2007. Additionally, in a related release, the SEC requested comments on a proposed definition of "significant deficiency."[3] The new definition was adopted by the SEC on July 25, 2007 and is effective September 10, 2007.[4]

For more information regarding the SEC's interpretive guidance and new rules related to evaluations of the effectiveness of internal control over financing reporting, please contact a member of Vorys Corporate and Finance Group by calling 614.464.6400.

The SEC coordinated the Guidance and rule amendments with the Public Company Accounting Oversight Board ("PCAOB"). The PCAOB adopted new Auditing Standard No. 5: An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements ("AS No. 5"), to supersede Auditing Standard No. 2, the PCAOB's current auditing standard governing ICFR. AS No. 5 is intended to work in conjunction with the Guidance and rule amendments. The SEC approved AS No. 5 on July 25, 2007. AS No. 5 is effective and required for audits conducted for fiscal years ending on or after November 15, 2007, but earlier adoption is permitted and encouraged.[5]

I. Interpretive Guidance

Since the enactment of Section 404 of the Sarbanes-Oxley Act and the requirement for management's report on the effectiveness of ICFR, the SEC has provided little guidance on the conduct of annual evaluations of ICFR. As an unintended result, many companies followed Auditing Standard No. 2. To help fill this gap, the SEC issued the Guidance; however, the SEC noted that its interpretive guidance issued in May 2005 on information technology general controls remains relevant. The Guidance is not mandatory and companies may continue to use the processes and procedures they currently have in place so long as they comply with applicable SEC rules implementing Section 404. The new rules, however, recognize a

This alert is for general information purposes only and does not constitute a full legal analysis of the subject matter discussed herein. The information in this alert should not be relied upon as specific legal advice, which should be given only after a thorough and complete review of all relevant facts and circumstances in each case.

"safe harbor" under which a management evaluation conducted in accordance with the Guidance will presumptively satisfy the requirements of Section 404 and applicable SEC rules.

The purpose of ICFR is to provide a "reasonable assurance" that the company's financial statements, and the methods used to prepare them, are reliable and are in accordance with generally accepted accounting principles ("GAAP"). Management's assessment is conducted to determine whether the Company's ICFR is effective as of the end of the fiscal year. Material weaknesses, if identified in the assessment, will likely lead to a determination that ICFR is not effective. A "material weakness" is a deficiency or combination of deficiencies in ICFR such that there is a reasonable possibility that a material misstatement of the company's financial statements will not be prevented or detected on a timely basis.

The Guidance is organized around two core principles:

- First, management should evaluate the design of existing controls to determine whether they adequately address the risk that a material misstatement in the company's financial statements would not be prevented or detected in a timely manner. The Guidance presents a top-down, risk-based approach, including evaluating the role of entity-level controls in assessing financial reporting risks and the adequacy of controls. The Guidance does not require management to evaluate and document every single control in a process, but rather permits management to focus its evaluation and supporting documentation on those particular controls that it believes adequately address the risk of material misstatements in financial statements. For instance, if an entity-level control addresses the risk for a particular element, no further evaluation of other controls is required.

- Second, management's evaluation of evidence regarding the operation of its controls should be based on its assessment of risk. The Guidance provides an approach for making risk-based judgments about the evidence needed for the evaluation, allowing management to align the nature and extent of its evaluation procedures with the areas of financial reporting that pose the highest risk to reliable financial reporting. The intended result is that management may use more efficient approaches to gathering evidence in low-risk areas, and perform more extensive testing in high-risk areas.

The purpose of the foregoing principles is to permit companies of all sizes and complexities to implement the SEC's rules effectively and efficiently.

The Guidance reiterates that the SEC expects management to use its own experience and informed judgment in designing an evaluation process that both meets the company's needs and provides a reasonable basis for a determination that ICFR is effective. Systems will vary in complexity with the size of the company.

The Guidance addresses both the evaluation process and reporting considerations, each of which are addressed below.

A. The Evaluation Process

1. Identifying Financial Reporting Risks and Controls

a. Identifying Financial Reporting Risks. Management must identify those risks of misstatement which could, alone or in combination with others, result in a material misstatement in the company's financial statements. The risk identification process will ordinarily begin by evaluating how GAAP requirements apply to the company's business, operations and transactions. The Guidance describes a risk-based approach that requires management to use its knowledge and understanding of the business, and its organization, operations and processes to determine material areas of risk to reliable financial reporting, including risk of fraud. The methods and procedures for identifying financial reporting risks are expected to vary based on the size and complexity of the company.

b. Identifying Controls that Adequately Address Financial Reporting Risks. Management should evaluate whether the company has adequate controls in place to address the financial reporting risks identified in the prior step. Management may identify preventive controls, detective controls or a

combination of both as adequately addressing the identified risks. The Guidance does not require identification of all controls that may exist for each element or the identification of redundant controls. This permits management to focus on the most important control or the control for which effectiveness can be obtained more efficiently.

c. *Consideration of Entity-Level Controls.* When assessing financial reporting risks and identifying the controls that adequately address the identified risks, management should consider the company's entity-level controls. These controls may, on their own, adequately prevent or detect possible misstatements or may be designed to identify lapses in lower level controls. In its assessment, management should consider the design and operation of the entity-level control and whether its relationship to the financial reporting element is direct or indirect. When entity-level controls are effective for a particular risk, management may not need to identify any other controls.

d. *Role of Information Technology General Controls.* Management may identify automated controls or controls that depend upon the company's information technology. While information technology general controls alone will not ordinarily adequately address financial reporting risks, they may affect other controls.

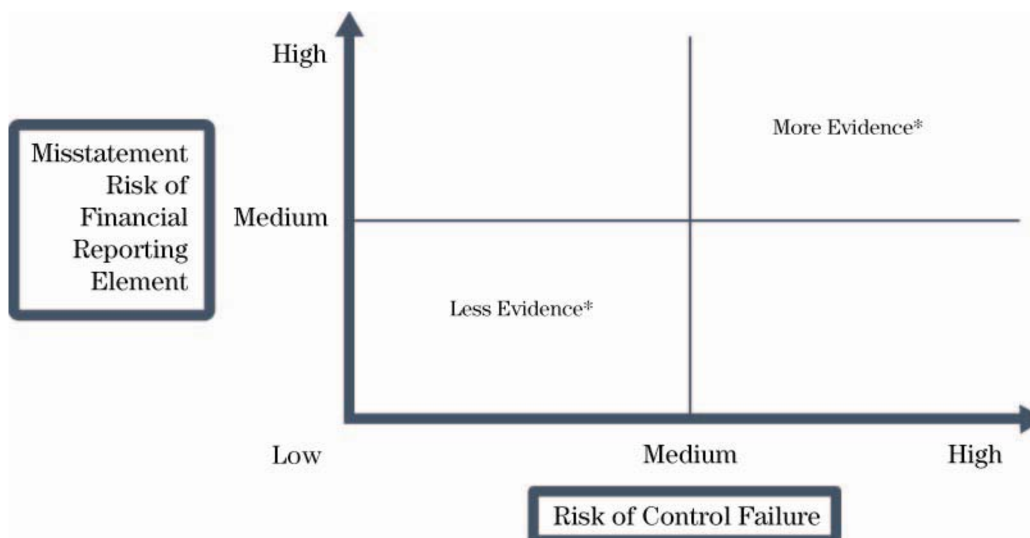
e. *Evidential Matter to Support the Assessment.* As part of its evaluation of ICFR, management must maintain reasonable support for its assessment. Documentation of the design of the controls that management has placed in operation, including both specific and entity-level controls, is required; however, the form and extent of documentation will vary depending on the size, nature and complexity of the company and may take different forms (such as paper or electronic). Additionally, the documentation does not need to address all of the company's controls that impact financial reporting, but rather should focus on the specific controls that management concludes are adequate to address financial reporting risks.

2. Evaluating Evidence of the Operating Effectiveness of ICFR

Once the risks, and their related controls, have been identified, management must evaluate evidence of the operating effectiveness of ICFR. This evaluation would ordinarily be focused on those specific areas of internal controls that pose the highest risk to reliable financial reporting.

a. *Determining the Evidence Needed to Support the Assessment.* The evaluation procedures used by management should be tailored to its assessment of the risk characteristics of both the individual financial reporting elements and the related controls. As the materiality of the financial reporting element increases in relation to a possible risk of misstatement, the assessment of risk for that element will correspondingly increase, requiring more evidence to demonstrate sufficiency.

The SEC used the following diagram to demonstrate this sliding scale:



* The references to "more" or "less" include both the quantitative and qualitative characteristics of the evidence (that is, its sufficiency).

Financial reporting elements involving significant accounting estimates, related party transactions and critical accounting policies will generally be assessed as having higher misstatement risk. Similarly, controls that are subject to the risk of management override, that involve significant judgment or are complex should generally be assessed as having higher risk.

b. Implementing Procedures to Evaluate Evidence of the Operation of ICFR. The methods and procedures used by management to gather evidence about the operating effectiveness of controls are a function of the evidence management considers necessary to support its assessment of ICFR based on the corresponding risk. The evidence may come from on-going monitoring or direct testing of specific controls. Management's evaluation of the evidence considers whether the control operated as designed, including how it was applied, the consistency with which it was applied, and whether the person performing the control possessed necessary authority and competence to perform the control effectively.

c. Evidential Matter to Support the Assessment. Management's assessment must be supported by evidential matter that provides reasonable support for its assessment. In determining whether evidence obtained is sufficient to provide reasonable basis for its evaluation, management should consider both the quantity and quality of the evidence. The amount of evidence may vary based upon the assessed level of risk, and the higher level of risk, the more evidence required to demonstrate sufficiency. The evidential matter may take varying forms depending on level of risk the control is designed to address. Documentation might include memoranda, e-mails, and instructions or directions from management to company employees.

3. Multiple Location Considerations

Management's consideration of financial reporting risks generally includes all of the company's locations or business units. However, in some cases, risks are adequately addressed by centrally-located controls. When performing its overall evaluation, management should consider any location-specific risks that might impact whether a control will operate effectively.

B. Reporting Considerations

1. Evaluation of Control Deficiencies

If a control deficiency or a combination of deficiencies is determined to be a material weakness, management may not conclude that the company's ICFR is effective. To determine whether a deficiency is a material weakness, management must evaluate the severity of the deficiency, as well as the effect of any compensating controls. The evaluation to determine if there are material weaknesses is a facts and circumstances analysis. Any material weaknesses identified must be disclosed in management's report on ICFR, and any significant deficiency must be reported to the audit committee and the company's independent auditors. Management evaluates the severity of the deficiency by considering (i) whether there is a reasonable possibility that a misstatement of a financial statement amount or disclosure would not be prevented or detected by the company's ICFR, and (ii) the magnitude of the potential misstatement. The Guidance identified the following non-exclusive factors that could affect the failure to prevent or detect a misstatement:

- The nature of the financial reporting elements involved (for example, suspense accounts and related party transactions involve greater risk);
- The susceptibility of the related asset or liability to fraud (susceptibility increases risk);
- The subjectivity, complexity or extent of judgment required to determine the amount involved (judgments, such as accounting estimates, increase risk);
- The interaction or relationship of the control with other controls (including interdependency and redundancy);
- The interaction of the deficiencies (whether different deficiencies could affect the same financial statement amounts or disclosures); and
- The possible future consequences of the deficiency.

Further, the Guidance identified the following non-exhaustive list of factors that could affect the magnitude of a misstatement:

- 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.

The Guidance also states that management should evaluate all relevant information, including the following indicators of potential material weakness, to determine whether a deficiency in ICFR exists and, if so, whether it is 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 in current period financial statements under circumstances that indicate that the misstatement would not have been detected by the company's ICFR; and
- Ineffective audit committee oversight of the company's external financial reporting and ICFR.

Although the presence of any of the above could indicate a material weakness, the presence of an indicator does not require management to conclude that a material weakness exists. Instead, management must use its judgment in this area.

When evaluating the severity of a deficiency or combination of deficiencies in ICFR, management should determine the level of assurance that would satisfy "prudent officials" that they have reasonable assurance that the financial statements are in conformity with GAAP. If management determines that the deficiency or combination of deficiencies might prevent prudent officials from concluding that they have reasonable assurance that the transactions are recorded in accordance with GAAP, then management should treat the deficiency or combination thereof as an indicator of material weakness.

2. Expression of Assessment of Effectiveness of ICFR by Management

Management should clearly disclose its assessment of the effectiveness of ICFR and should not qualify its assessment by stating that the company's ICFR is effective subject to certain qualifications or exceptions. If a material weakness exists, management may not conclude that ICFR is effective. Management may, however, state that the company's ICFR is not effective and provide the specific reasons why.

3. Disclosures about Material Weaknesses

The underlying goal of all disclosure in this area is to provide investors with disclosure and analysis that goes beyond disclosing the mere existence of a material weakness. Thus, disclosure should include the nature of the weakness, its impact on the company's financial reporting and ICFR and management's current plans, if any, and actions already undertaken for remediating the weakness. Companies should consider providing disclosure that allows investors to understand the cause of the control deficiency and to assess the potential impact of each particular material weakness on the company's financial statements.

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

When a material misstatement in previously issued financial statements is discovered and the financials are restated, the restatement does not, by itself, require management to consider the effect of the restatement on its prior conclusion of ICFR effectiveness. However, the Guidance states that, although management is not required to revisit its previous conclusion of ICFR effectiveness, the company should consider the effect of the restatement on previous disclosure and whether previous disclosure should be supplemented or modified to

include any information necessary to make it not misleading. Similarly, management should consider whether its original disclosures concerning disclosure controls and procedures need supplementing to make them not misleading and the impact, if any, the restatement had on the original conclusion that disclosure controls and procedures are effective. The company must also disclose any material changes to ICFR as required by Item 308(c) of Regulation S-K.

5. Inability to Assess Certain Aspects of ICFR

In certain circumstances, a company may have difficulty assessing certain aspects of its ICFR. This is particularly true where management outsources a significant process to a service provider. Management, however, is not allowed to issue a report on effectiveness of ICFR with a scope limitation. Therefore, if management does not have compensating controls in place, or is unable to obtain evidence of adequate controls from the service provider, it must determine whether the inability to assess controls at the service provider is significant enough to conclude that ICFR is not effective.

II. Rule Amendments

A. Amendments to Rules 13a-15 and 15d-15 under the Securities Exchange Act of 1934 Addressing Management's Evaluation of Effectiveness of Company's ICFR

SEC Rules 13a-15 and 15d-15 were simultaneously amended to correspond to the new Guidance, and now provide that an evaluation conducted in accordance with the Guidance will satisfy the SEC's rules. Each of Rule 13a-15 and 15d-15 now state that, although there are many different ways to conduct an evaluation of the effectiveness of ICFR, an evaluation conducted in accordance with the Guidance will satisfy the evaluation requirement under the rule, thereby providing a "safe harbor." The Guidance, however, is not mandatory and companies have the option to continue using their current procedures.

B. Amendments to Rules 1-02(a)(2) and 2-02(f) of Regulation S-X Addressing Independent Auditor's Opinion on Effectiveness of ICFR

Under the previous rules, auditors opined as to both management's assessment of the effectiveness of ICFR and the underlying ICFR. The SEC has amended Regulation S-X to require auditors to now opine only as to the actual effectiveness of the company's ICFR, eliminating the requirement of a second opinion as to management's assessment. The rationale for this change is that an auditor's opinion on the effectiveness of ICFR necessarily conveys whether management's assessment is fairly stated. However, although the requirement of a separate opinion on management's assessment is eliminated, AS No. 5 requires auditors to modify their opinion if they believe that management's assessment of ICFR is not fairly stated.

C. Amendments to Rule 12b-2 under Securities Exchange Act of 1934 and Rule 1-02 of Regulation S-X to Provide Definition of "Material Weakness"

A purpose of management's annual assessment of the effectiveness of ICFR is to identify any "material weakness." If management finds no material weakness, it can conclude ICFR is effective; if there is a material weakness, then it cannot conclude ICFR is effective.

Under Auditing Standard No. 2, which many companies have used, the standard as to whether a deficiency constituted a material weakness was whether it presented "more than a remote likelihood" that a material misstatement of financial statements would not be prevented or detected on a timely basis. Under the new rules adopted by the SEC, a "material weakness" is present if a deficiency, or a combination of deficiencies, in ICFR creates a "reasonable possibility" that a material misstatement of the company's financial statements would not be prevented or detected on a timely basis. This change corresponds to newly adopted AS No. 5, which defines "reasonably possible" as a chance that the occurrence of the event is more than remote, but less than likely. However, commenters on the new Guidance have asserted that the old and new definitions appear to be essentially the same, so the practical effect of the revised definition is unclear.

D. *Definition of Significant Deficiency*

Although they may not rise to the level of material weakness, management must communicate significant deficiencies to the audit committee and the company's independent auditor. In connection with the issuance of the new rules described above, the SEC requested comment on a proposed amendment to Rule 12b-2 under the Securities Exchange Act of 1934 and Rule 1-02 of Regulation S-X to add a definition of "significant deficiency." Under this definition, a "significant deficiency" is a deficiency, or a combination of deficiencies, in ICFR that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company's financial reporting. On July 25, 2007, the SEC adopted this definition which will take effect on September 10, 2007. Additionally, AS No. 5 uses the same definition of significant deficiency.

III. Coordination with PCAOB

Auditing Standard No. 5, which was recently adopted by the PCAOB and was approved by the SEC on July 25, 2007 (and evidenced by the SEC's order dated July 27, 2007), is aligned in many respects with the Guidance and the rule amendments. AS No. 5 uses the same definitions for material weakness and significant deficiency, identifies the same indicators of a material weakness, and also emphasizes the role of entity-level controls and a top-down approach to risk management. The SEC anticipates that AS No. 5 and the Guidance will together make Section 404 audits and management's assessment of ICFR more risk-based and scalable to the size and complexity of the company. AS No. 5 is effective and required for audits conducted for fiscal years ending on or after November 15, 2007, but earlier adoption is permitted and encouraged.

[1] SEC Release Nos. 33-8810; 34-55929 is available at http://www.sec.gov/rules/interp/2007/33-8810.pdf.

[2] SEC Release Nos. 33-8809; 34-55928 is available at http://www.sec.gov/rules/final/2007/33-8809.pdf.

[3] SEC Release Nos. 33-8811; 34-55930 is available at http://www.sec.gov/rules/proposed/2007/33-8811.pdf.

[4] SEC Release Nos. 33-8829; 34-56203 is available at http://www.sec.gov/rules/final/2007/33-8829.pdf.

[5] SEC Release No. 34-56152 is available at http://www.sec.gov/rules/pcaob/2007/34-56152.pdf.

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