Section 404 Update: SEC Issues Guidance on Internal Control over Financial Reporting

By Jane K. Storero & Tracey M. Todd

Jane K. Storero, a partner at Blank Rome LLP, advises companies on securities offerings, mergers and acquisitions and compensation disclosure. Ms. Storero also advises boards of directors on corporate and securities law issues including corporate governance matters. Tracey M. Todd is an associate in the Public Companies Group at Blank Rome LLP. Contact: Storero@BlankRome.com.

On June 20, the Securities and Exchange Commission released its long awaited guidance regarding the controversial Sarbanes-Oxley Act Section 404 rules that require an annual evaluation of internal control over financial reporting (“ICFR”). The SEC adopted this guidance along with conforming changes to certain of its rules on May 23, 2007, but delayed the release of the guidance and related rule changes pending the Staff’s review of the companion PCAOB proposal on Auditing Standard No. 5. The SEC interpretive guidance is effective on June 27, 2007.

On May 24, the PCAOB adopted Auditing Standard No. 5, which codified previously issued auditing guidance on the “top-down, risk-based approach” and revised the definition of material weakness. The PCAOB guidance is the companion to the new SEC guidance described above and was amended to align the auditing standard with the SEC guidance. The new auditing standard is subject to SEC approval and anticipated to be effective for calendar year 2007.

In companion release, the SEC also amended its rules to provide that an evaluation of ICFR conducted in accordance with the SEC’s new interpretive guidance would satisfy the annual management evaluation required by Section 404 of the Sarbanes-Oxley Act. The amended rules provide a non-exclusive safe-harbor for the purposes of compliance with SEC rules regarding management’s evaluation of the effectiveness of ICFR.

In addition, the SEC amended its accounting rules regarding the auditor’s attestation report requirements. The amended rules clarify that the external auditor is required to express only a single opinion directly on the effectiveness of the company’s ICFR in its attestation report rather than expressing separate opinions directly on the effectiveness of the company’s ICFR and on the management’s assessment of ICFR.

The SEC also revised its rules to include a definition of the term “material weakness.” Finally, the revised SEC rules define “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 in a timely basis.” These revised SEC rules are effective on August 27, 2007.

In another release, the SEC requested additional comment on the definition of the term “significant deficiency.” Because this term is used in the SEC’s rules, which require management to communicate all significant deficiencies in the design or operation of ICFR to the Company’s external auditors and the audit committee of the board of directors, the SEC believes that a definition of this term should be included in its rules, in addition to being defined in the auditing standards promulgated by the PCAOB. The SEC requested comments on the definition of “significant deficiency” on or before July 18, 2007.

The New SEC Guidance

SEC rules mandate that management maintain 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 generally accepted accounting principles. The rules implementing Section 404 of Sarbanes-Oxley require that management annually evaluate whether ICFR is effective at providing such reasonable assurance and disclose its assessment in the company’s Form 10-K.

The SEC’s interpretive guidance is intended to assist management of public companies planning for and performing the required annual management assessment of ICFR. The SEC guidance is intended to serve as one way for management to evaluate and assess ICFR, and sets forth an approach by which management can conduct a “top-down, risk-based” evaluation of ICFR. Under the amended SEC rules, an evaluation that complies with the new SEC guidance will satisfy the management’s evaluation requirements and provide management with certainty that it has satisfied its obligation to conduct an evaluation pursuant to those rules.

The new SEC guidance is based upon two broad principles:

1. Management’s evaluation of whether it has implemented controls that adequately address the risk that a material misstatement of financial statements would not be prevented or detected in a timely manner. The guidance describes a “top-down, risk-based approach” to this principle and promotes efficiency by allowing management to focus on those controls that are needed to adequately address the risk of a material misstatement of its financial statements. The guidance does not require that management identify every control in a process or document impacting ICFR. Rather, management can focus its evaluation process, and the documentation supporting the assessment, on those controls that it determines adequately address the risk of a material misstatement of the financial statements. For example, if management determines that a risk of a material misstatement is adequately addressed by an entity-level control, no further evaluation of other controls is required.

2. Management’s evaluation of the evidence about the operation of its controls should be based on management’s assessment of the risk associated with those controls. The guidance provides an approach for making “risk-based judgments” about the evidence needed for the evaluation, and 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 reporting. The intended result is efficiency on the part of management in gathering evidence, such as performing self-assessments in low-risk areas and performing more extensive testing in high-risk areas.

The objective of the ICFR evaluation is to provide management 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. To meet this objective, the guidance provides that management should:

Identify the risks to reliable financial reporting;

Evaluate whether the design of the controls addressing those risks provide a reasonable possibility that a material misstatement of the financial statements would not be prevented or detected in a timely manner; and

Evaluate evidence about the operation of the controls included in the evaluation based on its assessment of risk.

The guidance describes the evaluation process in two parts. The first part of the guidance explains the identification of financial reporting risks and the evaluation of whether the controls that management has implemented adequately address those risks. The second part of the guidance explains an approach for making judgments about the methods and procedures for evaluating whether the operation of ICFR is effective. The guidance also addresses reporting considerations.

Under the guidance, management’s evaluation begins with identifying and assessing risks that could result in a material misstatement of the financial statements (“financial reporting risks”), including changes in those risks. Next, management identifies controls in place (including entity-level controls and information technology controls) and then assesses whether the controls in place are designed to adequately address the financial reporting risks identified.

Identifying Financial Reporting Risks

To identify financial reporting risks, the guidance suggests that management evaluate how the requirements of generally accepted accounting principles apply to the company’s business, operations and transactions and use its knowledge and understanding of the business, and its organization, operations, and processes to consider the sources and potential likelihood of misstatements in
Identifying Controls that Adequately Address Financial Reporting Risks

After identifying the company’s financial reporting risks, the guidance suggests that management should next evaluate whether it has controls placed in operation that adequately address those risks. As used in the guidance, controls are a specific set of policies, procedures, or activities designed to meet the objective of accurate financial reporting. Controls can be automated or manual and include, among other things: reconciliations; segregation of duties; review and approval authorizations; safeguarding and accountability of assets; or error or fraud prevention or detection measures.

The guidance specifically indicates that management may 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 risk. Therefore, when more than one control exists and each control adequately addresses a financial reporting risk, management may decide to select the control for which evidence of operating effectiveness can be obtained more efficiently.

At the end of this controls identification process, management will have identified for testing only those controls which are necessary to adequately address the risk of a material misstatement of the company’s financial statements and those for which evidence about their operation can be obtained most efficiently. The controls that management identifies as adequately addressing the financial reporting risks are then subject to procedures to evaluate evidence of the operating effectiveness.

The SEC anticipates that, for most companies, management's effort to comply with the SEC's rules in subsequent years should be significantly reduced because all subsequent evaluations should be more focused on changes in risks and controls, rather than on the identification of all financial reporting risks and the related controls. Further, in each subsequent year, the evidence necessary to reasonably support management's assessment will only need to be updated from the prior year and, not recreated in its entirety. It is anticipated that the new SEC guidance coupled with the related rule changes will result in more efficient and cost-effective compliance with the Sarbanes-Oxley Act Section 404 requirements.