



SEC DISCLOSURE RULES REGARDING INTERNAL CONTROL OVER FINANCIAL REPORTING

by Patrick J. Johnson

Overview

On June 5, 2003, the Securities and Exchange Commission (SEC) adopted rules that will require all companies subject to the reporting requirements of the Securities and Exchange Act of 1934 (1934 Act), other than registered investment companies¹, to include in their **annual reports** a report of management on the company's internal control over financial reporting. The rules require the registered public accounting firm that audited the company's financial statements included in the annual report to issue an attestation report on management's assessment of the company's internal control over financial reporting.

The rules also require management to evaluate any change in the company's internal control over financial reporting that occurred during a fiscal quarter which has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

The rules also amended certain of the rules and forms related to various certifications required by the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley Act).

The rules became effective August 14, 2003, but the dates for complying with these rules were recently extended.

- "Accelerated filers"² must begin to comply with the requirement for a management report and related registered public accounting firm report for such issuer's first fiscal year ending on or after November 15, 2004.

To prepare the report management must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, the effectiveness, as of the end of each fiscal year, of the issuer's internal control over financial reporting.

- Non-accelerated filers, and foreign private issuers that file annual reports on Form 20-F or Form 40-F, must include those reports in the annual report for such filer's first fiscal year ending on or after July 15, 2005.
- Companies must begin to comply with the rule requiring management to evaluate changes in internal control over financial reporting for the first periodic report due after the first annual report that must include management's report on internal control over financial reporting.

¹ Changes in rules regarding investment companies are not discussed herein.

² An "accelerated filer" is "an issuer after it first meets the following conditions as of the end of its fiscal year: (i) The aggregate market value of the voting and non-voting common equity held by non-affiliates of the issuer is \$75 million or more; (ii) The issuer has been subject to the requirements of Section 13(a) or 15(d) of the Exchange Act for a period of at least twelve calendar months; (iii) The issuer has filed at least one annual report pursuant to Section 13(a) or 15(d) of the Exchange Act; and (iv) The issuer is not eligible to use Forms 10-KSB and 10-QSB for its annual and quarterly reports."

In a speech the week of August 9, 2004, the SEC's chief accountant indicated that SEC staffers will likely recommend that some future initiatives will be put off at least temporarily to give corporate auditors time to comply with the internal control mandates. It is not clear which rules may be affected. We will keep you posted on further developments.

Background

Section 404 of the Sarbanes-Oxley Act requires the SEC to prescribe rules requiring each annual report filed by a 1934 Act reporting company, other than a registered investment company, to contain an internal control report which (i) states management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting and (ii) contains an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of such structure and procedures. Section 404 also requires every registered public accounting firm that prepares or issues an audit report on the company's annual financial statements attest to, and report on, the assessment made by management. The attestation must be made in accordance with standards for attestation engagements adopted by the Public Company Accounting Oversight Board (PCAOB).

Discussion

Definition of "Internal Control Over Financial Reporting"

The rules define "internal control over financial reporting" as:

A process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel, to provide **reasonable assurance** regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance

with generally accepted accounting principles (GAAP) and includes those policies and procedures that:

1. Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
2. Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and
3. Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements.³

Management Assessment and Report

The rules require that the management report on internal controls contain:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the registrant;
- A statement identifying the framework used by management to evaluate the effectiveness of the registrant's internal control over financial reporting;
- Management's assessment of the effectiveness of the registrant's internal control over financial reporting as of the end of the registrant's most recent fiscal year, including a statement as to whether or not such internal control is effective. This assessment must disclose any "material weakness"⁴ in the registrant's internal control over financial reporting that has been identified by management. Further, management may not conclude that the registrant's internal control over

³ In drafting its definition, the SEC looked to the 1992 report by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and the 1994 addendum and 1996 supplement thereto on internal control. The SEC definition encompasses the internal controls related to financial reporting objectives addressed in the COSO report.

⁴ Has the same meaning under generally accepted accounting standards and attestation standards. See discussion under *Attestation to Management's Internal Control Report*.

financial reporting is effective if there are one or more material weaknesses; and

- A statement that the registered public accounting firm that audited the registrant's financial statements included in the annual report has issued an attestation report on management's assessment of the registrant's internal control over financial reporting.⁵

To prepare the report management must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, the effectiveness, as of the end of each fiscal year, of the issuer's internal control over financial reporting.

The rules do not mandate the use of a particular framework for evaluation of the effectiveness of the company's internal control over financial reporting. Rather, management must base its evaluation on "a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment."

The SEC indicates that the framework established by the COSO report is suitable. It also suggests that a suitable framework must: be free from bias; permit reasonably consistent qualitative and quantitative measurements of a company's internal control; be sufficiently complete so that those relevant factors that would alter a conclusion about the effectiveness of a company's internal controls are not omitted; and be relevant to an evaluation of internal control over financial reporting.

The rules do not specify the method or procedures to be performed in an evaluation and it is expected that methods will vary from company to company. The SEC suggests that the assessment be sufficient both to evaluate the **design** and to test the **operating effectiveness** of the controls, including:

- controls over initiating, recording, processing and reconciling account balances, classes of transactions and disclosure and related assertions included in the financial statements;

- controls related to the initiation and processing of non-routine and non-systematic transactions;
- controls related to the selection and application of appropriate accounting policies; and
- controls related to the prevention, identification, and detection of fraud.

Companies must maintain evidential matter and documentation to provide reasonable support for management's assessment of the effectiveness of the company's internal control over financial reporting. The SEC suggests that such evidential matter should provide reasonable support:

- for the evaluation of whether the control is designed to prevent or detect material misstatements or omissions;
- for the conclusion that the tests were appropriately planned and performed; and
- that the results of the tests were appropriately considered.

The rules do not specify where the management report must appear in the company's annual report, but the SEC suggests that it be in proximity to the corresponding attestation report issued by the company's registered public accounting firm. The SEC expects that many companies will choose to place the internal control report and attestation report near the company's MD&A disclosure or in the portion of the report immediately preceding the company's financial statements.

Attestation to Management's Internal Control Report

Under the rules, every registered public accounting firm that audited the company's financial statements included in its annual report required by Section 13(a) or 15(d) of the 1934 Act and that contains management's assessment of the company's internal control over financial reporting must issue an attestation report on such assessment. Such report must be filed with the annual report. Pursuant to the Sarbanes-Oxley Act, the PCAOB sets the auditing standard to be used by the accounting firms in connection with these attestation reports. The PCAOB

⁵ These requirements differ slightly for those registrants who elect to file one report to satisfy both the SEC and FDIC internal control reporting requirements.

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adopted a rule setting forth such standard, Auditing Standard No. 2, on March 9, 2004, and the SEC approved the standard on June 17, 2004.

The standard adopted by the PCAOB requires that management do the following to enable the accounting firm to complete its audit of internal control over financial reporting:

- Accept responsibility for the effectiveness of the company's internal control over financial reporting;
- Evaluate the effectiveness of the company's internal control over financial reporting using suitable control criteria;
- Support its evaluation with sufficient evidence, including documentation; and
- Present a written assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year.

Auditors will likely require representations from management to that effect.

Under the PCAOB standard, the objective of the auditors is to obtain **reasonable assurance** that no **material weaknesses** exist as of the date specified in management's assessment. A "material weakness" is:

- a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

A "significant deficiency" is:

- a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with GAAP such that there is more than a remote likelihood that a

misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected.

A "control deficiency" exists:

- when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis.

Evaluation of Any Change in the Internal Control over Financial Reporting

The rules require an issuer's management, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, to evaluate any **change** in the issuer's internal control over financial reporting that occurred during the last fiscal quarter (or year in the case of a foreign private issuer), that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting, and to disclose such change in the relevant quarterly report (or annual report as the case may be).

Note that an issuer's certifying officers are already required to evaluate the effectiveness of the company's disclosure controls and procedures on a quarterly basis.

Although the rules do not require an issuer to disclose the reasons for a change or any other information about the circumstances surrounding the change, the SEC suggests that in light of Rule 10b-5, issuers should consider whether such information might constitute material information necessary to make the disclosure about the change not misleading.

Affected Companies

The rules apply to:

- domestic and foreign issuers⁶, including small business issuers, that are required to file periodic reports under Section 13(a) or 15(d) of the Exchange Act; and

⁶ Other than registered investment companies and asset-backed issuers.

- federally insured depository institutions or holding companies that are required to file periodic reports under Section 13(a) or 15(d) of the Exchange Act, regardless of whether such entities are subject to the FDIC's internal control report requirements.

The SEC has provided, however, that those insured depository institutions subject to (i) Part 363 of the FDIC's regulations (as well as holding companies permitted to file an internal control report on behalf of their insured depository institution subsidiaries) and (ii) the new reporting rules may file two separate management reports to satisfy the FDIC and SEC requirements, or one management report that satisfies both FDIC and SEC requirements.

Certifications

The SEC also adopted amendments to the form of certification to be included in periodic reports filed by issuers pursuant to Section 302 of the Sarbanes-Oxley Act. The amendments added to the required certification a statement that the principal executive and financial officers are responsible for establishing and maintaining internal control over financial reporting and have designed or caused to be designed under their supervision such controls to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting practices.⁷

The amendments to the form of Section 302 certification were effective as of August 14, 2003. Issuers may, however, modify the content of the certification to eliminate certain references to internal control over financial reporting until the first annual

report required to contain management's internal control report and in all periodic reports filed thereafter.

Practical Actions

In light of these rules, you may want to consider the following:

- Identify and review existing internal control over financial reporting systems;
- Establish/confirm a framework for evaluating the effectiveness of such internal controls;
- Establish processes of documenting and testing internal controls over financial reporting;
- Discuss in advance with your auditors the requirements for an attestation report;
- Bear in mind the SEC rules on auditor independence; do not delegate responsibility to design, implement or assess internal controls to your auditor;
- Establish a system to monitor any changes in your internal control over financial reporting; and
- Make sure that your lawyers are involved in drafting and reviewing statements to be included in all annual and quarterly reports and certifications with respect to internal control over financial reporting.

⁷ The amendments also require that Section 302 certifications be filed as exhibits to certain reports filed by issuers, including annual and quarterly reports, and that Section 906 certifications accompany as exhibits periodic reports containing financial statements. These amendments were effective as of August 14, 2003.

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We would be happy to assist you in complying with any of the preceding matters. Please contact one of the following Brooks Pierce advisors if you would like to discuss these issues.

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