

## SEC Adopts Final Rules Relating to Management's Report on Internal Control Over Financial Reporting

The SEC recently adopted final rules implementing the requirement in Section 404 of the Sarbanes-Oxley Act that each annual report on Form 10-K, 10-KSB, 20-F and 40-F contain a report on internal controls. The final rules also implement the requirement that the company's registered public accounting firm attest to, and report on, management's assessment of internal controls. For those not steeped in the accounting literature on internal controls, these rules are perhaps the most conceptually difficult of any adopted as part of the Sarbanes-Oxley reforms. In addition, the SEC staff is predicting that compliance with these rules will likely be more time consuming and expensive than any other set of changes brought about by the Sarbanes-Oxley Act. We have previously sent a Securities Alert that describes the SEC's proposed rules, which is available on our web site at [www.ropesgray.com](http://www.ropesgray.com) under "News and Events." Although the final rules are substantially similar to the proposed rules, the SEC made several important changes and clarifications that are noted below.

### Internal Control Report Disclosure Requirements

The final rules require that companies include in their annual reports on Form 10-K, 10-KSB, 20-F and 40-F an internal control report of management:

- Stating management's responsibilities for establishing and maintaining adequate internal control over financial reporting;
- Identifying the framework management used to conduct the required evaluation of the effectiveness of the company's internal control over financial reporting;
- Containing management's 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; and
- Stating that the company's independent auditors have issued an attestation report on management's assessment of the internal control over financial reporting.

Some companies, particularly large issuers, already include a management report on internal controls in their annual reports. These new requirements call for much more extensive disclosure, in particular relating to the assessment of the effectiveness of internal controls, than is typically included in these reports. The SEC believes that the final rules will require many companies to compile additional documentation, implement new processes, and train staff to effect the necessary evaluation of and report on internal controls.

### Internal Control Over Financial Reporting

In an attempt to stem the confusion about what internal controls are, the final rules define "internal control over financial reporting" as a process designed by, or under the supervision of, the principal executive and financial officers, and effected by the registrant's board of directors, management and other personnel, to

provide reasonable assurance about the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. This process includes policies and procedures that:

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

This definition of "internal control over financial reporting" is consistent with the definition of "internal accounting controls" in Section 13(b)(2)(B) of the Exchange Act, which all public companies are currently required to maintain.

## Assessment of Internal Control Over Financial Reporting

*Evaluation Framework.* The final rules require that management of each public company evaluate the effectiveness, as of the end of each fiscal year, of the company's internal control over financial reporting. This evaluation must be based on a framework, identified in the internal control report, that is a "a suitable, recognizable 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 framework that has been most widely recognized is the one developed by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission. The adopting release states that the COSO framework meets the requirements of the new rules<sup>1</sup>. The release cites a U.K. framework and a Canadian framework as examples of international frameworks that meet the standard.<sup>2</sup>

*Management's Assessment of the Effectiveness of Internal Control.* The annual report must contain a discussion of management's assessment of the effectiveness of the company's internal control over financial reporting. The release does not provide any specific guidelines for how detailed or extensive this discussion must be. The final rules are clear, however, that management cannot conclude that the company's internal control over financial reporting is effective if it identifies a material weakness. The term "material weakness" has the same meaning as under generally accepted auditing standards and attestation standards, being a deficiency "in the design or operation of internal control that could adversely affect a company's ability to record, process, summarize and report financial data consistent with the assertions of management in the company's financial statements."

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<sup>1</sup> It is apparently the only such framework in the United States that currently meets the requirements because the release states that other frameworks "may be developed within the United States in the future" that meet the standard.

<sup>2</sup> The [Guidance on Assessing Control](#) published by the Canadian Institute of Chartered Accountants and the [Turnbull Report](#) published by the Institute of Chartered Accountants in England & Wales. Some recognized evaluation frameworks used in foreign jurisdictions do not require management to state whether the company's internal controls are effective. The release makes clear that management of a foreign reporting company using such a framework must, nevertheless, still state whether the company's internal controls are effective.

In addition, the final rules require disclosure in quarterly and annual reports of significant changes in internal controls that were made during the fiscal quarter covered by the report or the last fiscal quarter in the case of an annual report.

*Evaluation Process.* The final rules do not specify the exact method or procedures management must use in performing its assessment, and the method of the assessment will vary from company to company. The assessment must be based on procedures sufficient both to evaluate the design and to test the operating effectiveness of the internal controls. Although not in the rule itself, the adopting release states that the controls to be assessed include, but are not limited to:

- 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.

Whatever the level of assessment performed, the adopting release is clear that "inquiry alone generally will not provide an adequate basis for management's assessment."

The final rules require management to maintain evidential matter, including documentation to provide reasonable support for its assessment.

Although a company's auditors may assist it in documenting its internal controls, to avoid auditor independence issues, management cannot delegate the assessment of its internal controls to its auditors and must be actively involved in the process.

## Placement of the Report

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

## Auditor Attestation Report on Management's Assessment

To satisfy Section 404(b) of the Sarbanes-Oxley Act, the final rules require a company to file with its annual report an attestation report from its registered public accounting firm on management's assessment of internal control over financial reporting. The Public Company Accounting Oversight Board has designated, and the SEC has approved, the AICPA's existing Statement on Standards for Attestation Engagements No. 10 as the applicable standard for this attestation, pending further standard setting by the PCAOB. The attestation report may be included as part of the accountant's report or may be separate from the report.

## Quarterly Certification Relating to Internal Control Over Financial Reporting

The existing rules adopted in connection with the Section 302 certifications require that the company disclose in its periodic reports whether there have been any significant changes in internal controls since the date of their last evaluation. A certification by the CEO and CFO that this disclosure has been made is part of the Section 302 certification. In addition to disclosing any significant changes, the new rules require management to evaluate any change that has materially affected or is reasonably likely to materially affect, the company's internal control over financial reporting. The rules do not specify the timeframe in which that quarterly evaluation must be conducted, nor is there any requirement that the results of the evaluation be disclosed in any filing although presumably it would be a part of the annual evaluation of the effectiveness of internal controls. The adopting release suggests, however, that companies will need to consider whether disclosure of a change in internal controls without a broader discussion on the circumstances surrounding the change may be information necessary to make the disclosure about the change contained in the quarterly report not misleading.

Although there does not appear to be a quarterly evaluation requirement for internal control over financial reporting, there is the existing requirement that management evaluate quarterly the effectiveness of the company's disclosure controls and procedures. As discussed below, internal control over financial reporting is subsumed, at least in significant part, under disclosure controls and procedures. Thus, at some level, management will need to conduct a quarterly evaluation of internal controls as part of the disclosure controls evaluation. The release suggests that because the evaluation is of the "overall" effectiveness of the company's disclosure controls and procedures, management has the ability to make reasonable judgments that evaluations should focus on developments since the most recent evaluation, areas of weakness or continuing concern or other aspects that merit attention. As an example, the release states that while system testing may be required as part of the annual evaluation of internal control, management may make a different determination as part of its quarterly evaluation of disclosure controls and procedures.

## **Distinction between Internal Control Over Financial Reporting and Disclosure Controls and Procedures**

The adopting release attempts to clarify the confusion over the relationship between internal control over financial reporting and disclosure controls and procedures, which companies are also required to maintain pursuant to Rule 13a-15 or 15d-15 under the Exchange Act. Readers hoping for a crisp delineation will be disappointed. The SEC states that while there is "substantial overlap" between the two, some elements of each system will not be subsumed under the other. One concrete example the release gives involves dual check signing requirements, which are part of internal controls but may not be part of disclosure controls.

## **Amendment to Section 302 Certification**

The final rules amend the form of the Section 302 certification that must accompany all periodic reports to add statements to the effect that:

- The CEO and CFO are responsible for designing, or causing to be designed (under their supervision) the required internal controls; and
- The company had disclosed in the periodic report any changes in internal controls that occurred during the most recent quarter that has materially affected, or is reasonably likely to material affect, internal controls.

Annex A to this Memorandum is the form of Section 302 Certification to be included with the annual report on Form 10-K and the quarterly report on Form 10-Q.

### **Types of Companies Affected**

The new rules do not apply to asset-backed issuers. Banks and thrifts, and related holding companies, that are subject to Part 363 of the FDIC's regulations can elect to provide two separate reports that satisfy the FDIC's requirements and the new Section 404 rules, or they can prepare a single management's report that satisfies both requirements.

### **Transition Period for Compliance with Rules Regarding Evaluation of, and Reports and Attestations on, Internal Controls and Procedures for Financial Reporting**

In recognition of the significant burdens imposed by the new rules, the SEC has provided an extended transition period for compliance with the new requirements.

- Companies defined as "accelerated filers" under Exchange Act Rule 12b-2 will need to comply as of the end of the first fiscal year ending on or after June 15, 2004 (*e.g.*, the 2004 annual report for calendar year companies).
- Small business issuers and foreign private issuers must comply with the requirements for their first fiscal year ending on or after April 15, 2005.

### **Section 302 and 906 Certifications Required as Exhibits**

In addition to amending the form of the Section 302 certifications, the release also addresses the requirement to file the Section 302 certification and to furnish the Section 906 certification, in each case as exhibits to the respective reports. With one exception, the final rules relating to the form and filing requirements of the 302 and 906 certifications will become effective 60 days after the publication of the release in the Federal Register. The one exception relates to the requirement in the form of the Section 302 certifications (in the introductory language in paragraph 4, and in paragraph 4(b), of the form) relating to management's establishing and designing internal control over financial reporting. Those provisions will not be required in the Section 302 certifications until the first annual report in which a company includes the internal control report required under Section 404. Conforming changes in the Section 302 certification requirements applicable to registered investment companies have been made by the final rules, although Section 404 of Sarbanes-Oxley does not apply to those entities.

### **Contact Information**

If you have any questions or would like to learn more about the proposed rules, please contact the lawyer who normally represents you.