

**SEC DEFINES “MATERIAL WEAKNESS” AND GIVES
GUIDANCE ON EVALUATION OF INTERNAL CONTROLS**

On June 20, 2007, the Securities and Exchange Commission adopted amendments to the rules governing management’s report on internal control over financial reporting and issued guidance to management in evaluating internal controls and making related disclosures.¹ These changes are designed to make management’s evaluation of internal controls more efficient and cost-effective by endorsing a top-down, risk-based approach prioritized by a focus on preventing material misstatements. The final rules will become effective on August 27, 2007. The interpretive guidance became effective on June 27, 2007.

Summary

The amendments adopted by the SEC:

- Create a safe harbor for companies that follow the SEC’s interpretive guidance, which focuses management’s report on internal controls on those risks that could result in a material misstatement of the financial statements;
- Provide a definition for the term “material weakness” in Regulation S-X; and
- Revise the requirements for auditor attestation reports to require the expression of a single opinion directly on the effectiveness of a company’s internal controls.

“Material Weakness” and “Significant Deficiency” Defined

Sarbanes-Oxley requires management to provide certain disclosure regarding material weaknesses and significant deficiencies, but until now, the SEC had not defined either term. The final rule release amended the rules to define “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 by the company’s internal controls.”

In a separate final rule release, the SEC adopted the definition of “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 the registrant’s financial reporting.”²

¹ See Securities Act Release No. 33-8809, File No. S7-24-06 (June 20, 2007), available at www.sec.gov/rules/final.shtml, and Securities Act Release No. 33-8810, File No. S7-24-06 (June 20, 2007), available at www.sec.gov/rules/interp.shtml.

² See Securities Act Release No. 33-8829, File No. S7-24-06 (August 3, 2007), available at www.sec.gov/rules/final.shtml.

Safe Harbor for Evaluations Under New Guidance

In 2003, the SEC adopted rules requiring management to report on the company's internal controls and include that report in the company's 10-K. Since that time, issuers and the accounting profession have developed policies and procedures for preparing such reports that have proven to be burdensome and time-consuming in practice. The SEC has now offered interpretive guidance focusing on a top-down approach and a safe harbor for companies that follow it that is intended to make the review process more cost-effective.

The guidance allows companies to focus their efforts on those areas that management identifies as posing the greatest risks that material misstatements in the financial statements will not be prevented or detected on a timely basis. The approach is a risk-based, top-down approach, in contrast to a "bottom-up" approach requiring identification and review of every control regardless of the potential to materially affect reported financial results. 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.

The term "entity-level controls" refers to internal control that have a pervasive effect on the entity's system of internal control such as controls related to the control environment (for example, management's philosophy and operating style, integrity and ethical values; board or audit committee oversight; and assignment of authority and responsibility); controls over management override; the company's risk assessment process; centralized processing and controls, including shared service environments; controls to monitor results of operations; controls to monitor other controls, including activities on the internal audit function, the audit committee, and self-assessment programs; controls over the period-end financial reporting process; and policies that address significant business control and risk management practices.

Following the new guidance gives companies a "safe harbor" under the Exchange Act, but since the SEC recognizes that there are many other ways for management to conduct an appropriate evaluation under Regulation S-X, compliance with the new guidance remains voluntary.

Management's Evaluation Process

The guidance is organized around two principles:

- First, management must identify risks to reliable financial reporting and evaluate whether controls exist to address them.
- Second, management must evaluate evidence about the operation of the identified controls, based on its assessment of risk.

In both steps, management may limit its evaluation to the issues that pose the most serious and substantial risks of a material misstatement.

The guidance does not provide a step-by-step checklist, leaving it to management to utilize its own experience and informed judgment in designing the evaluation process. Companies are invited to use the new guidance to scale and tailor their evaluation methods to fit their own facts and circumstances.

Under the new guidance, management should generally consider the following:

Identifying Financial Reporting Risks

The evaluation begins with the identification and assessment of risks to reliable financial reporting. Management should identify those risks of misstatement that could, individually or in combination with others, result in a material misstatement of the financial statements (“financial reporting risks”). Since management must provide investors with financial statements that fairly present the company’s financial statements in accordance with GAAP, management should begin with an evaluation of how the GAAP requirements apply to the company’s business and operations. Management should then consider the sources and potential likelihood of misstatements in financial statement amounts or disclosures (“financial reporting elements”). Internal and external risk factors may give rise to a risk of misstatement, and it may be useful for management to consider “what could go wrong” within a financial reporting element to identify the sources and likelihood of misstatements.

The process of identifying financial reporting risks varies based on the characteristics of the company. In large companies, a variety of company personnel with specialized knowledge may be needed to provide all of the requisite information. In smaller companies, management’s daily involvement in the business may provide it with adequate knowledge to identify financial reporting risks.

Identifying and Evaluating Controls

Management must then identify the controls it has in place and evaluate whether such controls adequately address the company’s financial reporting risks. This requires judgments about whether the controls, if operating properly, can effectively prevent or detect misstatements that could result in material misstatements in the financial statements. In identifying controls to evaluate, management may consider the efficiency with which evidence of the control’s operation can be evaluated. If more than one control addresses a financial reporting risk, management may elect to evaluate the control for which evidence of operating effectiveness can be obtained more efficiently.

In conducting its evaluation of controls, management must consider the nature of any “entity-level controls” and how those controls relate to a particular financial reporting element. If such entity-level controls would adequately prevent or detect financial reporting risks, management does not need to identify other controls that address those risks.

Management must also consider controls that are automated, dependent upon IT functionality, or a combination of both manual and automated procedures. This should not be a separate evaluation, but rather should be part of management’s overall approach to risk and control identification. Management needs to evaluate only those IT general controls that are necessary for the proper and consistent operation of other controls designed to adequately address financial reporting risks. There is no need to evaluate IT general controls relating to the efficiency of a company’s operations if they are not relevant to addressing financial reporting risks.

As part of its evaluation of internal controls, management must maintain reasonable support for its assessment through documentation of the design of the internal controls. Such documentation may be in the form of paper documents or electronic or other media, and can include policy manuals,

process models and job descriptions. The documentation does not need to include all existing controls that impact financial reporting, only those that management concludes are adequate to address financial reporting risks.

Evaluating Evidence of the Operating Effectiveness of Controls

After identifying financial reporting risks and adequate controls, management must evaluate the operating effectiveness of the controls. For example, management must consider whether the control operates as designed and whether the person performing the control can perform the control effectively. The guidance emphasizes that the evaluation should be tailored to management's assessment of risk with respect to the financial reporting elements as well as the controls. Management can ordinarily focus its evaluation on areas posing the highest financial reporting risks.

In evaluating the effectiveness of the internal controls, management must first consider the characteristics of the financial reporting elements to which the controls relate as well as the characteristics of the controls themselves. Some characteristics to consider with respect to the misstatement risk of financial reporting elements and the likelihood of control failure are listed below:

<u>Financial Reporting Elements</u>	<u>Internal Controls</u>
<ul style="list-style-type: none">• Involves judgment in determining the recorded amounts• Susceptibility to fraud• Has complex accounting requirements• Changes based on the nature or volume of underlying transactions• Sensitivity to environmental factors such as technological or economic developments	<ul style="list-style-type: none">• Type of control and frequency with which it operates• Complexity of the control• Risk of management override• Competence of the personnel performing the control or monitoring its performance• Changes in key personnel who perform the control or monitor its performance• Judgment required to operate the control• Nature and materiality of the misstatement that the control is intended to prevent or detect• Degree to which the control relies on other controls• Evidence of the operation of the control from prior years

After assessing risk, management must determine what evidence is necessary for its evaluation of the operating effectiveness of its controls. In order to obtain sufficient evidence, management may integrate evaluation procedures with the responsibilities of its employees, and may take into account evidence taken from direct testing of the controls and also from ongoing monitoring activities.

When internal controls risk is high, management must typically obtain evidence through direct testing or ongoing monitoring by individuals with a high degree of objectivity. If the risk is low, management can conclude that evidence from ongoing monitoring is sufficient and no direct testing is required.

Management must evaluate the evidence gathered to determine whether the operation of a control is effective. The evidential matter that management compiles must provide reasonable support for management's assessment of the internal controls. The evidential matter will normally include documentation of how management came to its conclusion regarding the effectiveness of its internal controls. Depending on the level of risk and the size of the company, evidential matter within the company's books and records may be sufficient to provide such reasonable support.

Consideration of Multiple Locations

If controls to address financial reporting risks operate at more than one location or business unit, management generally must evaluate the evidence of the effectiveness of such controls at the individual locations or business units. If the financial reporting risks are low, management may decide that evidence from ongoing monitoring activities, in addition to evidence from centralized control, constitutes sufficient evidence for the evaluation.

Other Reporting Considerations

In addition to the recommendations regarding the evaluation process, the guidance also suggests that management consider providing additional disclosure about control effectiveness:

Management's Assessment of Control Effectiveness

Management must evaluate the severity of each control deficiency, based on quantitative and qualitative factors, to determine whether it is a material weakness. If one or more control deficiencies are deemed to be a material weakness, then management cannot state in its assessment that the internal controls are effective. If management determines that the control deficiency is a significant deficiency (as defined above), it must be reported to the company's audit committee and external auditor. In determining whether a control deficiency constitutes a material weakness, management can evaluate the effect of compensating controls, which may have a mitigating effect.³

Disclosures about Material Weaknesses

The disclosure requirements surrounding material weaknesses were intended to bring information about such material weaknesses into the public view. While management is only required to include in its annual report that its internal controls are ineffective when there are material weaknesses, the SEC believes companies should consider providing disclosure to allow investors to understand the cause and impact of the control deficiency. In particular, companies should consider including the following in their disclosures:

³ Compensating controls are controls that serve to accomplish the objective of another control that did not function properly, helping to reduce risk to an acceptable level.

- The nature of any material weakness;
- The impact on the company's financial reporting and its internal controls; and
- Management's current plans or actions undertaken for remediating the material weakness.

Impact of Restatement of Previously Issued Financial Statements

If previously issued financial statements are restated, management should consider whether its original disclosures are still appropriate. Management should consider modifying its original disclosure to include any other material information that is necessary for such disclosures not to be misleading in light of the restatement.

Auditors to Express a Single Opinion on the Effectiveness of Internal Controls

Under the current rules, auditors in their attestation reports express an opinion as to the effectiveness of the company's internal controls and also another opinion on whether management's assessment of the internal controls is fairly stated. In the final rule release, the SEC revised Regulation S-X to clarify that only one opinion directly on the effectiveness of management's internal controls is required in the auditor's attestation report.

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If you have any questions regarding this memorandum, please contact Bruce Kraus (212-728-8237, bkraus@willkie.com) or the attorney with whom you regularly work.

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