
SEC FLASH REPORT

SEC Staff Issues Responses to Frequently Asked Questions Regarding Management's Report on Internal Control Over Financial Reporting and Disclosure in Exchange Act Periodic Reports

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The Securities and Exchange Commission (SEC) has posted a frequently asked questions document on its website regarding management's issuance of internal control reports in compliance with Section 404 and disclosure in Exchange Act periodic reports. These responses address questions the SEC staff has received from time to time regarding the implementation and interpretation of the Commission's rules. Eighteen questions are listed addressing the following topics, among others:

- Entities consolidated based on characteristics other than voting control, including certain variable interest entities and entities accounted for via proportionate consolidation
- Investments accounted for under the equity method
- Material acquisitions during the fiscal year
- Management's reporting on internal controls
- Timing of application of the accelerated filer test
- Disclosures relating to changes or improvements to controls made as a result of preparation for the first management internal control report
- Disclosures relating to significant deficiencies and material changes in internal control over financial reporting
- Timing of assessing internal control over financial reporting of certain foreign entities
- Definitions of significant deficiency and material weakness
- Same auditor of outsourcing and service organizations
- Guidance to small business issuers
- Auditor independence

The answers to these frequently asked questions represent the views of the staffs of the Office of the Chief Accountant and the Division of Corporation Finance. These responses are not official rules, regulations or statements of the SEC, and the Commission has neither approved nor disapproved them. To understand the staff's views, there is no substitute for reviewing the document released by the Commission. Interested parties may go to <http://www.sec.gov/info/accountants/controlfaq0604.htm> to obtain the document. We have summarized the staff's views on certain topics below.

Certain Entities Consolidated Based on Characteristics Other Than Voting Control, Including Certain Variable Interest Entities and Entities Accounted for via Proportionate Consolidation

The SEC typically expects management's report on internal control over financial reporting to address the controls at all consolidated entities, irrespective of the basis for consolidation. However, there may be situations where the entity was in existence prior to December 15, 2003 and is consolidated by virtue of FASB Interpretation No. 46 (meaning the entity would not have been consolidated in the absence of application of that guidance). Or they may be situations where the registrant does not have the right or authority to modify or assess the internal controls of the consolidated entity and also lacks the ability, in practice, to make that assessment, such as when a company is accounted for via proportionate consolidation in accordance with EITF 00-1. In such situations, the SEC staff believes management should disclose either in the internal control report or elsewhere in the body of the annual report that it has not evaluated the internal controls of the entity in question and should also note that the registrant's conclusion regarding the effectiveness of its internal control over financial reporting does not extend to the internal controls of that entity. The registrant should also disclose total assets, net assets, revenues and net income that result from consolidation of entities whose internal controls have not been assessed. The disclosure should note that management has been unable to assess the effectiveness of internal control at certain entities included in the consolidated financial statements due to the fact that the registrant does not have the ability to dictate or modify the controls of the entities and does not have the ability, in practice, to assess those controls.

Investments Accounted for Under the Equity Method

Investee companies accounted for under the equity method are not consolidated on a line-by-line basis in the investor's financial statements. Therefore, the investee company's controls over the recording of transactions into the investee's accounts are not part of the issuer's internal control structure. However, the issuer must have controls that ensure the investment is properly recorded in its consolidated financial statements.

Material Acquisitions During the Fiscal Year

The SEC provides relief on the issue of acquired entities of such size it is impossible for management to complete an assessment of their internal control over financial reporting during the period between the consummation date and the acquirer's fiscal year-end. While the staff indicated it is expected that management would ordinarily include in its scope the controls at all consolidated entities, they acknowledged that it might not always be possible to conduct an assessment of an acquired entity's internal control over financial reporting in sufficient time. Therefore, the staff would not object to management excluding the acquired business from management's report on internal control over financial reporting so long as there is adequate disclosure the acquired business is excluded and the issuer discloses any material change to its internal control

over financial reporting due to the acquisition. In addition, the period in which management may omit an assessment of an acquired entity's internal control over financial reporting from its assessment of the acquiring entity's internal control may not extend beyond one year from the date of acquisition, nor may such assessment be omitted from more than one annual management internal control report.

Management's Reporting on Internal Controls

Management may not qualify the internal control report. For example, management cannot state that the company's controls and procedures are effective except to the extent that certain problems have been identified or express similar qualified conclusions. Management must take those problems into account when concluding whether the registrant's internal control over financial reporting is effective.

Timing of Application of the Accelerated Filer Test

The question is often asked as to when a registrant determines whether it is an accelerated filer for purposes of determining when it must comply with Section 404. A registrant that is not already subject to accelerated filing should determine whether it is an accelerated filer at the end of its fiscal year, based on the market value of its public float of its common equity as of the last business day of its most recently completed second fiscal quarter. Consideration should also be given to other components of the accelerated filer definition.

Disclosures Relating to Changes or Improvements to Controls Made as a Result of Preparation for the First Management Internal Control Report

Generally the SEC expects a registrant to make periodic improvements to internal controls and would welcome disclosure of all material changes to controls, whether or not made in advance of the compliance date of the rules under Section 404 of the Sarbanes-Oxley Act. However, the staff would not object if a registrant did not disclose changes made in preparation for the registrant's first management report on internal control over financial reporting. That said, if the registrant were to identify a material weakness, it should carefully consider whether that fact should be disclosed, as well as changes made in response to the material weakness.

After the issuance of the registrant's first management report on internal control over financial reporting, pursuant to Item 308 of Regulations S-K or S-B, the registrant is required to identify and disclose any material changes in its internal control over financial reporting in each quarterly and annual report. This would encompass disclosing a change (including an improvement) to internal control over financial reporting that was not necessarily in response to an identified significant deficiency or material weakness (i.e. the implementation of a new information system) if it materially affected the registrant's internal control over financial reporting.

Disclosures Relating to Significant Deficiencies and Material Changes in Internal Control Over Financial Reporting

A registrant must identify and publicly disclose all material weaknesses. If management identifies a significant deficiency, it is not obligated to publicly disclose the existence or nature of the significant deficiency. However, if management identifies a significant deficiency that, when combined with other significant deficiencies, is determined to be a material weakness, management must disclose the material weakness and, to the extent material to an understanding of the disclosure, the nature of the significant deficiencies.

If a material change is made to either disclosure controls and procedures or to internal control over financial reporting in response to a significant deficiency, the registrant is required to disclose such change and should consider whether it is necessary to discuss further the nature of the significant deficiency in order to render the disclosure not misleading.

Timing of Assessing Internal Control Over Financial Reporting of Certain Foreign Entities

Many registrants with global operations have a lag in reporting the financial results of certain foreign subsidiaries for financial reporting purposes. For example, the staff provided an example of a 30-day lag, i.e., a registrant with a December 31 year-end may consolidate the operations of certain foreign subsidiaries with a November 30 year-end. This difference in period ends is acceptable in relation to the assessment of internal control over financial reporting.

Definitions of Significant Deficiency and Material Weakness

The SEC staff will apply the PCAOB definitions of “significant deficiency” and “material weakness” in interpreting the Commission’s rules.

Same Auditor of Outsourcing and Service Organizations

In situations where management has outsourced certain functions to third party service provider(s), management retains responsibility for assessing the controls over the outsourced operations. However, management would be able to rely on a Type 2 SAS 70 report even if the auditors for both companies were the same. On the other hand, if management were to engage the registrant's audit firm to also prepare the Type 2 SAS 70 report on the service organization, management would not be able to rely on that report for purposes of assessing internal control over financial reporting. Management is still responsible for maintaining and evaluating, as appropriate, controls over the flow of information to and from the service organization.

Guidance to Small Business Issuers

Although the SEC's final rule implementing Section 404 of the Act does not distinguish between large and small issuers, the Commission, as noted in the release accompanying the final rule, recognized that many smaller issuers might encounter difficulties in evaluating their internal control over financial reporting. The SEC staff would support efforts by bodies such as COSO to develop an internal control framework specifically for smaller issuers.

Auditor Independence

The auditor is allowed to provide limited assistance to management in documenting internal controls and making recommendations for changes to internal controls. However, management has the ultimate responsibility for the assessment, documentation and testing of the registrant's internal controls over financial reporting.