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SEC Staff Publishes Views on Management's Report on Internal Control Over Financial Reporting

The SEC staff recently published a set of frequently asked questions ("FAQs") that clarify the position of the staff with respect to the interpretation and application by the staff of the rules of the SEC on internal control over financial reporting and certification of disclosure in periodic reports applicable to SEC reporting companies. The SEC rules implement the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act").

The following is a summary discussion of the FAQs. The staff noted that the FAQs represent the views of the staff only. They are not rules, regulations or statements of the SEC.

In addition, we have updated our memorandum "SEC Adopts Rules Regarding Internal Audit Over Financial Reporting" to reflect the staff's views expressed in the FAQs. The updated memorandum, which contains a detailed discussion of the requirements of Section 404 of the Act, is available on our website (www.paulweiss.com) under Capital Markets and Securities publications.

The FAQs provide guidance on the staff's position with respect to the following:

Certain Consolidated Entities (FIN 46 and EITF 00-1)

A reporting company's internal control over financial reporting is expected to cover all consolidated entities, irrespective of the basis for consolidation. However, in situations where a reporting company does not have the right or authority to assess the internal controls of the consolidated entity and also lacks the ability, in practice, to make that assessment (for example, in the case of entities consolidated pursuant to FIN 46 or accounted via proportionate consolidation in accordance with EITF 00-1), the company should provide disclosure in its Form 10-K, 20-F or 40-F to the effect that management has been unable to assess the effectiveness of internal control at those entities. The company should also disclose key sub-totals (such as total and net assets, revenues and net income) for consolidated entities whose internal control have not been assessed.

Equity Method Investments

A reporting company's internal control over financial reporting is not expected to cover entities accounted for as an equity method investment. However, the company must have controls

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over the recording of amounts related to its investments that are recorded in the consolidated financial statements.

Acquired Businesses

Management may omit an assessment of the internal control over financial reporting of an acquired business for up to one year from the date of acquisition or one annual management report on internal control over financial reporting, whichever is sooner, if it is not possible to conduct an assessment of the internal controls of such acquired business between the date of the acquisition and the date of management's assessment. In such instances, the company should provide disclosure in its Form 10-K, 20-F or 40-F to the effect that management excluded the acquired business from its report on internal control over financial reporting. Disclosure must also identify the acquired business being excluded and indicate its significance to the company's consolidated financial statements. Notwithstanding exclusion of an acquired business's internal controls, a company must disclose any material change to its internal control over financial reporting due to the acquisition, as required by Rules 13a-15(d) or 15d-15(d) and Regulation S-K, Item 308.

Outsourced Activities

If a company outsourced certain functions to third party service providers (for example, payroll or information technology), management retains responsibility to assess the controls over the outsourced operations. However, management may rely on a Type 2 SAS 70 report performed by the auditors of the third party service provider even if the auditors for both companies were the same or if the reports are as of a different year-end. However, management may not rely on a Type 2 SAS 70 report if it engaged the company's audit firm to also prepare such report on the third party service provider.

Management's Report and Related Attestation Report of Auditor

- Management may not qualify its conclusions with respect to the effectiveness of the company's internal control over financial reporting. Rather, management must take those problems into account when concluding whether the company's internal control over financial reporting is effective. Management may state that controls are ineffective for specific reasons. The presence of a material weakness will prevent management from concluding that internal control is effective.

- If a company reports the financial results of certain subsidiaries with different period-ends for financial reporting purposes, management's assessment of internal control over financial reporting may also be conducted and reported upon using those different period-ends.

- In connection with the development of an assessment process and a documentation process in preparation for issuing management's report on the company's internal control over financial reporting, management is allowed to rely on the company's auditor 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 company's internal controls.

- An auditor may combine its report on management's assessment on internal control with the audit report on the financial statements. However, in making its decision, an auditor should consider any issues that may arise if its audit report on the financial statements is expected to be reissued or incorporated by reference into a filing.

- A company is required to provide management's report on internal control over financial reporting , as well as the related auditor attestation report, when filing a transition report on Form 10-K, 20-F or 40-F. The transition provisions relating to management's report on internal control should be applied to the transition period as if it were a fiscal year. Transition reports on 10-Q are not required to include a management report on internal control over financial reporting.

- In case the report of management or the auditor or both conclude that a reporting company's internal control over financial reporting is not effective, the company would continue to be considered timely and current for purposes of the availability of Rule 144 and Forms S/F-2, S/F-3 and S-8, so long as the company's other reporting obligations are timely.

Disclosure Rules

- If management's report on internal control over financial reporting does not identify a material weakness but the accountant's attestation (audit) report does, or vice versa, this would normally not be a disclosable event under Item 304 of Regulation S-K, unless the situation results in a change in auditor that would require disclosure under Item 304. However, differences in identification of material weaknesses could trigger other disclosure obligations.

- A reporting company is not required to disclose publicly the existence or nature of identified significant deficiencies. However, if the combination of significant deficiencies were to rise to the level of a material weakness, the material weakness must be disclosed and, if material to the understanding of the material weakness, the company should consider whether the nature of the significant deficiencies must also be disclosed. In addition, if a material change is made either to disclosure controls and procedures or to internal controls over financial reporting in response to a significant deficiency, the material change must be disclosed and, if material to the understanding of the change, the company should consider whether the nature of the significant deficiency must also be disclosed in order to render the disclosure not misleading.

Definitions

The staff indicated that the definition of internal control over financial reporting does not encompass a company's compliance with applicable laws and regulations, with the exception of compliance with the applicable laws and regulations related to the preparation of financial statements. Not all aspects of the Act and the rules promulgated thereunder fall within that definition. For example, while the SEC's financial reporting requirements and the Internal Revenue Code are directly related to the preparation of the financial statements rules relating to the disclosure of code of ethics or an audit committee financial expert are not so directly related.

However, as part of the evaluation of the company's disclosure controls and procedures, management must consider compliance with other laws, rules and regulations. Evaluation of disclosure controls and procedures and internal control over financial reporting in respect of compliance with laws and regulations does intersect at certain points, including, for example, whether a company has controls to ensure that the effects of non-compliance are recorded in the financial statements, including the recognition of probable losses under FASB Statement No. 5, *Accounting for Contingencies*.

In addition, the staff clarified that to the extent the PCAOB modified certain definitions (for example, the definitions of "significant deficiency" and "material weakness") used by the Act or rules promulgated thereunder, the staff of the SEC will apply the PCAOB definitions in interpreting the SEC rules in this area. See, PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*.

Transition Provisions

- A company must determine whether it is an accelerated filer at the end of its fiscal year, based on the market value of the public float of its common shares as of the last business day of its most recently completed second fiscal quarter.

- The staff would welcome, but does not require, a reporting company to disclose changes or improvements to controls made as a result of preparing for the company's first management report on internal control over financial reporting. However, if the company 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.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Paul Weiss Securities Group, including:

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