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SEC Tackles a Wide Range of Topics

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Introduction

The Securities and Exchange Commission (SEC or the "Commission") has been active over the past few weeks, tackling a wide range of topics, summarized in the table below:

Topic	Highlight
Issued interpretive guidance for management's internal control evaluations	Release 34-55929, effective immediately, provides management with much-anticipated guidance ("SEC's Final Management Guidance") on evaluating internal controls over financial reporting (ICFR).
Amended rules on management's report on internal controls	To help management and auditors comply more effectively and efficiently with Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act"), Release 34-55928 amends rules regarding management's report on ICFR. The amendments, effective August 27, 2007, define the term "material weakness" and revise requirements for the auditor's attestation report on the effectiveness of ICFR.
Proposed a definition of significant deficiency	Release 34-55930 requests comments on the term "significant deficiency" as used in the Commission's rules on implementing Sections 302 and 404 of the Act.
Proposed changes for smaller public companies	Following up on recommendations made by its Advisory Committee on Smaller Public Companies,[1] the SEC is proposing a variety of rule changes to make it easier and more cost-effective for these companies to raise capital.
Established an advisory committee to improve financial reporting	The SEC established an advisory committee to focus on strategies to (1) reduce complexity in accounting rules, (2) clarify application guidance, and (3) make financial results more useful and understandable.

1 See the final report of the Advisory Committee on Smaller Public Companies.

The Final Management Guidance and the related rule amendments were approved at the SEC's May 23, 2007, open meeting covered in Deloitte and Touche LLP's May 31, 2007, *Heads Up*.

Read on for further highlights on each of these topics.

SEC's Final Management Guidance (Release 34-55929)

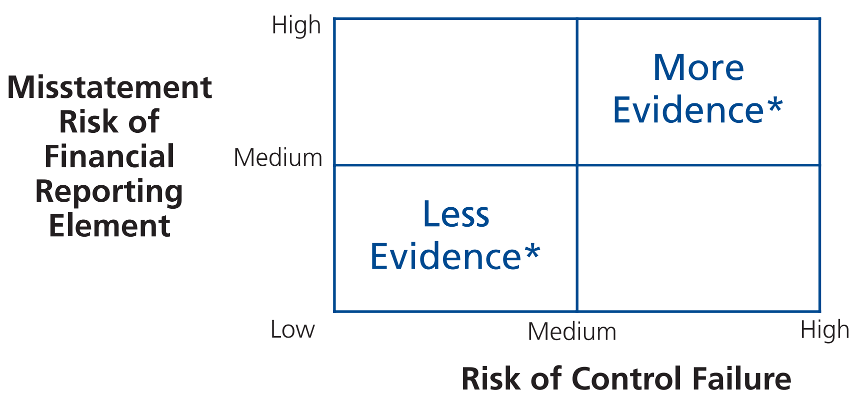
The SEC's Final Management Guidance calls for a "top-down, risk-based" approach to management's evaluation of ICFR, including the following:

1. Identifying financial reporting risks and the related controls that address those risks, including consideration of entity-level controls and information technology.
2. Evaluating the operating effectiveness of controls, including determination of the evidence needed to support management's assessment.
3. Assessing financial reporting risks across multiple locations, including location-specific risks; determining which controls are relevant to address those risks; and identifying the level of control testing at individual locations.
4. Reporting the overall results of management's assessment, including how to evaluate deficiencies, make disclosures about material weaknesses, and handle the impact of a restatement.

The following chart summarizes some of the key provisions of the SEC's Final Management Guidance:

Key Provisions of SEC's Final Management Guidance
Requires management to use an internal control framework (such as the Internal Control — Integrated Framework created by the Committee of Sponsoring Organizations of the Treadway Commission).
Establishes identification and evaluation of controls necessary to address the risk of material misstatement as the objective of management's assessment of ICFR.
Stipulates that consideration of financial reporting risks should include all locations/business units, including determination of whether risks are adequately addressed by central controls.
Establishes that assessments must be supported by evidence that provides reasonable support for conclusions reached, acknowledging that the form and extent of documentation may vary from entity to entity.
Permits use of a combination of direct testing and ongoing monitoring activities to obtain evidence regarding operating effectiveness.
Provides that management's approach to testing may differ from the auditor's.
Recommends that management consider the interaction of different controls and compensating controls in determining whether a deficiency, or combination of deficiencies, is a material weakness.

Throughout, the interpretive guidance focuses on the evidence management needs to support its assessment and emphasizes that this evidence must be reasonable and sufficient. The SEC provided the following diagram to help management determine this sufficiency:



* The references to "more" or "less" include both the quantitative and qualitative characteristics of the evidence (that is, its sufficiency).

As the diagram illustrates, the interpretive guidance allows management to use a significant amount of judgment in making this determination. The interpretive guidance also provides additional points for management to consider in determining the level of misstatement risk of the financial reporting element and the risk of control failure.

How does the SEC's Final Management Guidance differ from the guidance proposed in December 2006 (see Deloitte and Touche LLP's January 8, 2007, *Heads Up*)? Although similar to the proposed guidance, the final release identifies the following improvements made in response to comments from constituents:

- Better alignment with PCAOB guidance on various topics.
- Expanded discussion of entity-level controls.
- Clarification that fraud risks are expected to exist at every company.
- Explanation of how the nature and level of evidence obtained from ongoing monitoring activities and direct testing varies depending on the risk of misstatement of the financial reporting element or control failure.
- Clearer identification of which information technology controls should be focused on.
- Emphasis that the evaluation of deficiencies requires a consideration of all relevant facts and circumstances.

Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting (Release 34-55928)

Management's Use of New Guidance to Satisfy Section 404 Requirements

The amendments state that a company that performs its ICFR evaluation in accordance with the final interpretive guidance will satisfy the Section 404 requirements. However, the SEC also emphasized that management can satisfy these requirements by continuing to use effective processes that are already in place.

Defining Material Weakness

The amendments define a "material weakness" as follows:

> 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.

The definition was revised to be consistent with the definition used by the PCAOB in its revised auditing standard.

Separate Audit Report on Management's Assessment No Longer Required

The amendments eliminate the requirement for auditors to express a separate opinion about management's assessment of ICFR. Auditors who have performed an integrated audit of a registrant's ICFR and financial statements will now express one opinion that covers the effectiveness of ICFR and another opinion about the financial statements. This change is consistent with, and will take place on the effective date of, the PCAOB's revised auditing standard.

Definition of the Term "Significant Deficiency" (Release 34-55930)

The SEC also proposed, and is requesting comments on, the term "significant deficiency" as used in the Commission's rules on implementing Sections 302 and 404 of the Act. The proposed definition, as revised, would be consistent with the definition used by the PCAOB in its revised auditing standard. Comments on the proposed guidance are due on July 18, 2007.

Proposals for Smaller Public Companies

Following up on recommendations made by its Advisory Committee on Smaller Public Companies,[2] the SEC is proposing a variety of rule changes to make it easier and more cost-effective for these companies to raise capital. The following proposals are designed to benefit issuers while not compromising investor protection. Look for an additional SEC proposal designed to benefit smaller public companies in the weeks ahead.

Proposal to Allow Smaller Companies to Use Shelf Registration Statements (Forms S-3 and F-3)

By using Form S-3 (and its companion, Form F-3, for foreign private issuers), companies may conduct primary offerings "off the shelf." That is, a company may register securities offerings before planning any specific offering and, once the registration statement is effective, offer securities in one or more tranches without waiting for further SEC action. According to the proposal, "By having more control over the timing of their offerings, these companies can take advantage of desirable market conditions, thus allowing them to raise capital on more favorable terms (such as pricing) or to obtain lower interest rates on debt."

Under the current rules, only companies with a public float[3] of $75 million or more may take advantage of Forms S-3 and F-3. Under the proposal, any company may use Forms S-3 and F-3, as long as it (1) satisfies the other eligibility requirements of the form and (2) does not sell more than 20 percent of its public float in offerings under these forms in any 12-month period. The proposals would not extend to shell companies. The SEC estimates that about 5,000 additional companies will be able to use Forms S-3 and F-3 as a result of the proposed change. Comments on the proposal are due by August 27, 2007.

Proposal Easing the Requirements for Unregistered Offerings (Rules 144 and 145)

To make it easier for companies to raise capital in unregistered offerings, often used by smaller companies, the proposal makes many changes to Rules 144 and 145. The changes are expected to increase the liquidity of privately sold securities, thereby decreasing the cost of capital for companies.

Under Rule 144, restricted securities (generally issued in a private placement) may be sold to the public without full registration if certain conditions are met. In some cases, one condition requires that purchasers of the shares own them for at least one year before any resales. Under the proposal, purchasers of unregistered shares issued by companies that are subject to Exchange Act[4] reporting requirements need only own the shares for six months as long as the purchaser does not hedge its exposure.

Today, a purchaser is limited in the number of shares that it may sell after the one-year holding period. Under the proposal, a purchaser who is not an *affiliate* of the entity may sell an unlimited amount of shares at the expiration of the holding period. Among the proposal's other changes are reducing filing requirements for certain sales and simplifying Rule 144. Comments on the proposal are due by September 4, 2007.

Proposal on Electronic Filing and Simplification of Form D

The proposal would mandate the electronic filing on the SEC's Web site of information required by Form D of the Securities Act of 1933. (Form D is a notice of the sale of securities that are exempt from registration and provides empirical data to assist the SEC in addressing the capital formation needs of small businesses.) In addition, the proposal would restructure and simplify Form D by revising the information requirements, making the data more relevant and easily searchable by regulators and members of the public. Comments on the proposal are due by September 7, 2007.

2 See the final report of the Advisory Committee on Smaller Public Companies.
3 Nonaffiliate equity market capitalization.
4 The Securities Exchange Act of 1934.

SEC Committee on Improvements to Financial Reporting

The SEC is establishing an Advisory Committee on Improvements to Financial Reporting. The committee will focus on strategies to reduce complexity and make financial results more useful and understandable. Robert C. Pozen, chairman of MFS Investment Management and former vice chairman of Fidelity Investments, will chair the committee.

Here are the Committiee's planned areas of focus:

- The current approach to standard setting.
- The current process of regulating compliance (by registrants and financial professionals) with accounting and reporting standards.
- The current systems for delivering financial information to investors.
- Environmental factors that may increase complexity and reduce transparency.
- Whether the costs of certain accounting and reporting standards outweigh their benefits.
- Whether the cost-benefit analysis is likely to be affected by the increasing use of international accounting standards.

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