

Discussion Document C – November 21, 2006 Joint Meeting of International Practices Task Force (IPTF) and SEC Staff

Topic: Scope of Management’s SOA 404 Assessment and Proportionately Consolidated Entities

Background:

Section 404 of the Sarbanes-Oxley Act becomes effective for large accelerated foreign private issuers (“FPIs”) in fiscal years ending on or after July 15, 2006. Under a recently adopted change by the SEC, accelerated foreign private issuers are required to furnish a management assessment only in their filings for the same fiscal year, while full adoption is delayed until fiscal years ending on or after July 15, 2007. Many of these FPIs prepare their primary financial statements using International Financial Reporting Standards (“IFRS”) or other local standards that permit proportionate consolidation of certain affiliates. While proportionately consolidated on a line-by-line basis, the investor usually does not exercise unilateral control over the affairs of the affiliate. Accordingly, management of these entities must decide whether the accounts of these affiliates must be included within the scope of Section 404 internal controls assessment.

In 2003, the SEC staff stated in “Management’s Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports Frequently Asked Questions” (SEC Section 404 FAQs) its views on the scope of management's assessment as it relates to consolidated entities (e.g., variable interest entities). The SEC staff indicated that management's report on internal control over financial reporting typically should include controls at all consolidated entities, irrespective of the basis for consolidation. For instance, the SEC staff indicated that the internal controls of an entity consolidated by virtue of “FASB Interpretation No. 46(R) (revised December 2003), Consolidation of Variable Interest Entities” (FIN 46), should be covered in management's report on internal control over financial reporting if the registrant's initial involvement with the variable interest entity occurred after December 15, 2003. However, in a situation where the entity was in existence prior to December 15, 2003 and is consolidated by virtue of FIN 46 (i.e., would not have been consolidated in the absence of application of that guidance) and where the registrant 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, the SEC staff believes management’s report on internal control over financial reporting should provide disclosure regarding such entities. Finally, the SEC staff further indicated that the disclosure should note that the financial statements include the accounts of certain entities consolidated pursuant to FIN 46 or accounted for via proportionate consolidation in accordance with EITF 00-1, but that management has been unable to assess the effectiveness of internal control at those entities 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. (See Appendix for the text of Section 404 FAQs 1.)

Issue:

Considering the above-mentioned guidance in the SEC Section 404 FAQs, would managements of FPIs that proportionately consolidate entities in their primary GAAP financial statements include these entities within the scope of their Section 404 assessments?

Task Force Discussion:

The Task Force understands that the SEC Staff believes that FPI management should look to the primary GAAP (e.g., IFRS) used to prepare their financial statements when making their scope assessments under Section 404. Consequently, the presumption is that the scope of Section 404 should include all entities that are consolidated line-by-line, whether proportionately or otherwise in the primary financial statements. The Task Force also understands that there may be instances that prevent management from assessing the controls of a proportionately consolidated entity, because management may not have the right or authority to dictate or modify the controls at the affiliate and does not have the ability, in practice, to assess those controls.

In this situation, management's report on internal control over financial reporting should provide disclosure in the body of its Form 20-F regarding such entities. For example, an FPI could refer readers to a discussion of the scope of management's report on internal control over financial reporting in a section of the annual report entitled "Scope of Management's Report on Internal Control Over Financial Reporting." The FPI should disclose in the body of the Form 20-F that it has not evaluated the internal controls of the entity and should also note that the FPI's conclusion regarding the effectiveness of its internal control over financial reporting does not extend to the internal controls of the entity. The FPI should also disclose any key sub-totals, such as total and net assets, revenues and net income that result from consolidation of entities whose internal controls have not been assessed. The disclosure should note that the financial statements include the accounts of certain entities accounted for via proportionate consolidation in accordance with primary GAAP but that management has been unable to assess the effectiveness of internal control at those entities due to the fact that the FPI 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.

Finally, the Task Force noted that in order to overcome the presumption (i.e., all entities that are consolidated in the primary financial statements are within scope of Section 404) it believes that management would need to assert and have persuasive documented evidence regarding its inability to obtain a controls evaluation for the proportionately consolidated entity based on the facts and circumstances (e.g., contracts, joint venture agreements, and/or legal opinions).

Staff Response:

The Staff agrees with the Task Force discussion.

Appendix:

In their FAQs on Internal Controls Reporting, the SEC staff addressed in 2003 the following question in a related topic:

Question 1

Financial Accounting Standards Board (FASB) Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities – An Interpretation of ARB No. 51, requires that registrants apply that guidance and, if applicable, consolidate entities based on characteristics other than voting control no later than the period ending March 15, 2004, or December 15, 2004 for small business issuers. In instances where the registrant lacks the ability to dictate or modify the internal controls of an entity consolidated pursuant to Interpretation No. 46, it may not have legal or contractual rights or authority to assess the internal controls of the consolidated entity even though that entity's financial information is included in the registrant's financial statements. Similarly, for entities accounted for via proportionate consolidation in accordance with Emerging Issues Task Force Issue No. 00-1 (EITF 00-1), management may not have the ability to assess the internal controls. How should management's report on internal control over financial reporting address these situations?

Answer

We would typically expect management's report on internal control over financial reporting to include controls at all consolidated entities, irrespective of the basis for consolidation. However, in a situation where the entity was in existence prior to December 15, 2003 and is consolidated by virtue of Interpretation No. 46 (i.e., would not have been consolidated in the absence of application of that guidance) and where the registrant 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, we believe management's report on internal control over financial reporting should provide disclosure in the body of its Form 10-K or 10-KSB regarding such entities. For example, a registrant could refer readers to a discussion of the scope of management's report on internal control over financial reporting in a section of the annual report entitled "Scope of Management's Report on Internal Control Over Financial Reporting." The registrant should disclose in the body of the Form 10-K or 10-KSB that it has not evaluated the internal controls of the entity 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 the entity. The registrant should also disclose any key sub-totals, such as total and net assets, revenues and net income that result from consolidation of entities whose internal controls have not been assessed. The disclosure should note that the financial statements include the accounts of certain entities consolidated pursuant to FIN 46 or accounted for via proportionate consolidation in accordance with EITF 00-1 but that management has been unable to assess the effectiveness of internal control at those entities 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.

