



CAQ Alert #2008-94 – December 31, 2008

DEAR CENTER MEMBERS

SEC's Findings of Section 404(a) Deficiencies for First Time Filers

The staff of the Securities and Exchange Commission's (SEC or the Commission) Division of Corporation Finance participated in the PCAOB's Forums on Auditing in the Small Business Environment ([Small Business Forums](#)) during 2008. Participants at these Small Business Forums included auditors from smaller PCAOB-registered public accounting firms and directors and financial executives of smaller public companies. During the presentation at the Small Business Forums, staff from the SEC's Division of Corporation Finance discussed common financial reporting issues facing smaller registrants.

Among the information provided during these Small Business Forums, the SEC staff discussed certain observations related to management's Section 404(a) compliance requirements. The staff of the Division of Corporation Finance performed targeted reviews of the disclosures for management's assessment of internal control over financial reporting of non-accelerated filers that had performed an evaluation and assessment for the first time in 2007 (Section 404(a)). Below is a list and summary of certain deficiencies that the SEC discovered in their review of these filings:

1. Companies began but did not finish their assessment
In certain circumstances, companies indicated that they were unable to complete their evaluation due to insufficient time or resources.
2. Companies were silent as to whether they did an evaluation and assessment
In many cases, companies did not include any disclosure that explicitly stated whether or not they conducted an evaluation or any indication of the conclusion on effectiveness. Some registrants indicated to SEC staff that they were confused about the distinction between internal control over financial reporting and disclosure controls and procedures and that two separate assessments are required.
3. Companies did not believe they were required to conduct an evaluation
For various reasons, some registrants incorrectly believed that they were not required to conduct an evaluation. Among some of the reasons provided included inappropriately concluding that registrants were newly public companies as well as a belief that the requirement for management's assessment had also been deferred.
4. Companies did not perform an assessment because they consummated a reverse merger or were a shell company
A limited number of companies did not complete an assessment because they did not believe it applied to shell companies or they were a shell company that recently completed a reverse merger with an operating company. The SEC staff noted that these are not newly public companies; therefore, absent any discussions with the SEC staff on this topic, these companies are required to comply with Section 404(a) of the Sarbanes-Oxley Act of 2002.

5. Companies appear to have performed an assessment but did not disclose a conclusion

Some companies indicated in their disclosure that they did conduct an evaluation of internal control over financial reporting but did not disclose their conclusion on effectiveness regardless of whether they had disclosed material weaknesses or not.

The SEC staff noted that a filing that did not include the appropriate disclosures in full compliance with the SEC's rules implementing Section 404(a) of the Sarbanes-Oxley Act of 2002 represented a material deficiency in the filing and that issuers would not be deemed to be current or timely for the purposes of certain form eligibility. [Question 115.02](#) of the Division of Corporation Finance's Compliance and Disclosure Interpretations of Regulation S-K (updated 7/3/08) states the following:

It is the Division's view that the failure to provide this management report renders the annual report materially deficient. As a result, if management did not complete the evaluation and provide the report as required by Item 308T(a), the company would not be timely or current in its Exchange Act reporting. This would result in the company not being eligible to file new Form S-3 or Form S-8 registration statements and the loss of the availability of Rule 144. Because the filing of the Form 10-K constitutes the Section 10(a)(3) update for any effective Forms S-3 or S-8, the company also would be required to suspend any sales under already effective registration statements.

However, if the company subsequently amends its Form 10-K to provide management's report on whether or not internal control is effective, the company can file new Forms S-8 and resume making sales under already effective Forms S-8, and shareholders can avail themselves of Rule 144 (assuming all other conditions to use of the form or rule are satisfied). This would be the case regardless of whether management reached an effective or ineffective conclusion about its internal control. Although amending the Form 10-K to provide management's report may result in the company becoming current, it would remain untimely and would not be eligible to file new Forms S-3.

The SEC staff also reminded the participants that all registrants – INCLUDING NON-ACCELERATED FILERS, with limited exceptions, are currently required to perform an evaluation of Internal Control Over Financial Reporting (ICFR) and disclose that fact along with the conclusion on effectiveness in its Form 10-K. Guidance issued by the SEC staff in the Form of [Frequently Asked Questions](#) provides information on the limited situations in which it is acceptable for management not to report on ICFR.

The SEC staff also indicated that management must conclude on both Disclosure Controls and Procedures as well as ICFR. Each conclusion must explicitly state whether such controls are effective or ineffective.

Non-accelerated filers will not be required to include a related attestation report from the auditor in Form 10-K as required by Section 404(b) of the Sarbanes-Oxley Act of 2002 until fiscal years ending on or after December 15, 2009.

To view the complete [SEC staff presentation](#) at the Small Business Forums, please go to the SEC's website.

Please also refer to the Center for Audit Quality's [Alert #2007-66](#) on **Items to Consider Regarding Management's Report on Internal Control for Audits of Non-Accelerated Filers** when auditor attestation is not yet required under the SEC's transition provisions for non-accelerated filers. This specific alert contains helpful information for auditors regarding:

1. Possible Additional Audit Report Language; and
2. Other Factors for Auditors to Consider.

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