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July 5, 2007

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SEC Guidance Regarding Management's Report on Internal Control over Financial Reporting

I. Introduction

On May 23, 2007, largely in response to criticism that the implementation of Section 404 of the Sarbanes-Oxley Act of 2002 ("SOX") was complex, burdensome, and expensive, the Securities and Exchange Commission ("SEC") unanimously approved interpretive guidance to help public companies apply a top-down, risk based evaluation of their internal control over financial reporting ("ICFR"). The SEC anticipates that the interpretive guidance will allow companies of all sizes to implement the rules efficiently and effectively.

The interpretive guidance was released on June 20, 2007 along with amendments to Rules 13a-15(c) and 15d-15(c) under the Securities and Exchange Act of 1934.[1] The interpretive guidance is intended to provide companies with greater clarity and transparency about their obligations relative to Section 404; thereby promoting the preparation of reliable financial statements and preventing and detecting material misstatements. By encouraging management to bring its own experience and informed judgment to the evaluation process, the SEC anticipates that the pressure on management to look to auditing standards for guidance will be lessened.

A. *Section 404*

Section 404 of SOX requires that each annual report filed with the SEC contain an internal control report including: (1) a statement by management that management is responsible for establishing and maintaining an adequate internal control structure and procedure for financial

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[1] Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934 Release No. 33-8810, June 27, 2007, *available at* http://www.sec.gov/rules/interp/2007/33-8810.pdf.; Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting, Release No. 33-8809, August 27, 2007, *available at* http://www.sec.gov/rules/final/2007/33-8809.pdf. The text of amended Rules 13a-15(c) and 15(d)-15-(c) are attached hereto as Annex A.

reporting and (2) an assessment by the company's independent auditors, as of the end of the company's most recent fiscal year, as to the effectiveness of the company's internal control structure and procedures for financial reporting.

II. **Interpretive Guidance: Identifying Financial Reporting Risks and Controls**

The objective of ICFR is to provide reasonable assurance regarding the preparation and reliability of financial reporting for external purposes, in accordance with generally accepted accounting principles ("GAAP"). Exchange Act Section 13(b)(7) defines "reasonable assurance" and "reasonable detail" as "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs". These definitions are included for purposes of Section 13(b)(2), which was added to the Exchange Act by the Foreign Corrupt Practices Act of 1977 ("FCPA") and which requires a system of internal controls to operate at a level that provides reasonable assurance about the reliability of financial reporting. The interpretive guidance assumes that management has established and maintains a system of internal accounting controls as required by the FCPA.

In order to provide reasonable assurance regarding the preparation and reliability of financial reporting, management should: (1) identify the risks to reliable financial reporting; (2) evaluate whether controls exist to address those risks; and (3) evaluate evidence about the operation of the controls included in the evaluation, based on its assessment of risk. The interpretive guidance is based on two broad principles. First, management should focus only on those controls that are needed to adequately address the risk of material misstatements in financial statements. Second, management's evaluation should be based on its assessment of risk.

A. *Identifying Financial Reporting Risks*

The methods and procedures for identifying financial reporting risks will vary based on the size, complexity, organizational structure and processes of the company, the company's financial reporting environment, and the control framework used by management. The interpretive guidance suggests that management should evaluate how the requirements of GAAP apply to the company's business, operations and transactions. Such an evaluation will identify risks of misstatements that may individually or collectively result in material misstatements. Management should use its knowledge and understanding of the business, its organization, operations, and processes, to consider the sources and potential likelihood of misstatements. Financial reporting risks may arise from sources such as initiation, authorization, processing and recording of transactions, and other adjustments that are reflected in financial reporting elements. Internal and external risk factors (including the nature and extent of any changes to those risks) should be considered by management. A further consideration should be the vulnerability of the entity to fraudulent activity (e.g., fraudulent financial reporting, misappropriation of assets, and corruption) and whether any of those exposures could result in a material misstatement of the financial statements.

B. *Identifying Controls That Adequately Address Financial Reporting Risks*

Once a company has identified financial reporting risks, management should evaluate whether it has adequate controls in place to address the company's financial reporting risks. More specifically, the company must identify for evaluation those controls: (1) for which evidence about the operation can be obtained most efficiently; and (2) that are needed to provide a reasonable assurance regarding the reliability of financial reporting. For the purpose of the interpretive guidance, a control consists of a specific set of policies, procedures, and activities

designed to meet an objective. Controls may be preventative, having the objective of preventing the occurrence of errors or fraud. Controls may also be detective, having the objective of detecting errors or fraud that have already occurred. An individual control, or combination of controls, adequately addresses a financial reporting risk if, when operating properly, it can effectively prevent or detect misstatements that could result in material misstatements in financial statements. There may be more than one control that addresses the financial reporting risks of a financial reporting element. It is not necessary for management to identify all controls that may exist, unless redundancy itself is required to address the reporting risks.

C. *Consideration of Entity-Level Controls*

Management should consider the company's entity-level controls (those emanating from the top of the organization; eg., HR policies, management philosophies, code of conduct, etc.) when identifying financial reporting risks and assessing the adequacy of controls. It is important for management to consider the nature of the entity level controls and the relationship of the control to the financial reporting element. Some entity level controls such as environmental controls have an important, but indirect effect on the likelihood that a misstatement will be prevented or detected in a timely manner. Other entity level controls may be designed to identify possible breakdowns in lower level controls, but not in a manner that would by themselves adequately address financial reporting elements. The more indirect the relationship to the financial reporting element, the less effective a control may be in detecting a misstatement.

D. *Role of General Information Technology Controls*

Controls that management identifies as addressing financial reporting risks may be automated or dependent upon information technology ("IT") functionality or a combination of both. While general IT controls ordinarily do not directly prevent or detect material misstatements in the financial statements, the proper and consistent operation of automated or IT dependent controls depends upon effective general IT controls. Management's evaluation should generally consider the design and operation of the automated or IT-dependent controls and the relevant general IT controls over the applications providing the IT functionality. Aspects of general IT controls that may be relevant to the evaluation of ICFR will vary depending upon a company's facts and circumstances. Ordinarily, management should consider whether, and the extent to which, general IT control objectives related to program development, program changes, computer operations, and access to programs and data apply to its facts and circumstances. For purposes of the evaluation of ICFR, management need only evaluate general IT controls that are necessary to adequately address financial reporting risk.

E. *Evidential Matter to Support the Assessment*

As part of its evaluation of ICFR, management must maintain reasonable support for its assessment. Documentation of the design of the controls management has placed in operation to adequately address the financial reporting risk are an integral part of reasonable support. The form and extent of the documentation will vary depending on the size, nature and complexity of the company (paper documents, electronic, or media). The documentation may be presented in a number of ways (policy manuals, process models, flowcharts, job descriptions, documents, internal memorandums, forms, etc.). Documentation should focus only on those controls that management concludes are adequate to address the financial reporting risks.

III. Interpretive Guidance: Evaluating Evidence of the Operating Effectiveness of ICFR

Once management has identified the company's financial reporting risk and adequate controls have been put in place, evidence regarding the operating effectiveness of ICFR should be evaluated. The evaluation of operating effectiveness of a control considers whether the control is operating as designed and whether the person performing the control possesses the necessary authority and competence to perform the control effectively. Management should focus its evaluation on the areas posing the highest ICFR risk and tailor evaluation procedures to its assessment of the risk. Management should consider the impact of entity-level controls which may influence management's judgments about the risks of failure for particular controls. Evidence regarding the effectiveness of operation may be obtained from direct testing of controls or on-going monitoring of activities. The nature, timing and extent of the evaluation procedure will depend on the assessed ICFR risk. In determining whether the evidence obtained is sufficient to provide a reasonable basis for its evaluation of the operation of ICFR, management should consider not only the quantity of evidence, but also qualitative characteristics of the evidence. Qualitative characteristics include the nature of the evaluation procedures performed, the period of time to which the evidence relates, the objectivity of those evaluating the controls, and for monitoring controls, the extent of validation through direct testing of underlying controls. For any individual control, different combinations of the nature, timing, and extent of evaluation procedures may provide sufficient evidence, although the sufficiency of evidence is not determined by any of these attributes individually.

A. *Determining the Evidence Needed to Support the Assessment*

In order to determine the evidence needed to support the company's assessment, management should evaluate the ICFR risk by considering the characteristics of the financial reporting elements to which the controls relate and the characteristics of the controls themselves. Management's consideration of the misstatement risk of a financial reporting element includes both the materiality of the financial reporting element and the susceptibility of the underlying account balances, transactions or other supporting information to a misstatement that could be material to the financial statements. As the materiality of the financial reporting element increases in relation to the amount of misstatement that would be considered material to the financial statements, management's assessment of risk generally would correspondingly increase. Indicators of the level of risk include financial elements that:

(1) involve judgment in determining the recorded amount;

(2) are susceptible to fraud;

(3) involve complex accounting requirements;

(4) experience change in the nature or volume of the underlying transaction;

(5) are sensitive to change in environmental factors such as technological or economic developments.

Among other things, management's consideration as to whether a control may fail to operate effectively should include:

(1) the type of control and frequency with which it operates;

(2) the complexity of the control;

(3) the risk of management override;

(4) the judgment required to operate the control;

(5) the competence of the personnel who perform the control or monitor its performance;

(6) whether there have been changes in key personnel who either perform the control or monitor its performance;

(7) the nature and materiality of misstatements that the control is intended to prevent or detect;

(8) the degree to which the control relies on the effectiveness of other controls; and

(9) the evidence of the operation of the control from prior years.

Furthermore, when a combination of controls is required to adequately address the risks of a financial reporting element, management should analyze the risk characteristics of each control.

B. *Implementing Procedures to Evaluate Evidence of the Operation of ICFR*

The evaluation methods and procedures used to evaluate evidence that provides a reasonable basis for its assessment of the operating effectiveness of the company's controls may be integrated with the daily responsibilities of employees or implemented specifically for the purposes of ICFR evaluation. Management may obtain evidence from either direct tests of controls, on-going monitoring or a combination of both. Direct tests of controls are tests ordinarily performed on a periodic basis by individuals with a high degree of objectivity relative to the controls being tested. Direct tests provide evidence as of a point in time and may provide information about the reliability of on-going monitoring activities. On-going monitoring includes management's normal, recurring activities that provide information about the operation of controls. If ICFR risk is assessed as high, management will ordinarily increase the extent of validation through periodic direct testing of the underlying controls. Direct testing, which is more objective, may be used exclusively or to supplant or corroborate on-going monitoring. If management determines that ICFR risk is low, on-going monitoring may be sufficient and no direct testing will be required. In order to determine whether a control is effective, management must consider whether the control operated as designed, how the control was applied, the consistency with which it was applied, and whether the person performing the control possesses the necessary authority and competence to perform the control effectively.

C. *Evidential Matter to Support the Assessment*

Management must provide reasonable support for its assessment including the basis for the assessment and documentation of the methods and procedures the company utilizes to gather and evaluate evidence. The evidential matter will take varying forms and will depend on the assessed level of ICFR risk. The nature of supporting evidential matter will also depend on the degree of complexity of the control, and the risk of misstatement in the financial reporting element that could result in a material misstatement of financial statement. The evidential matters constituting reasonable support for management's assessment would ordinarily include documentation of how management formed its conclusion about the effectiveness of the company's entity level and other pervasive elements of ICFR that the applicable framework describes as necessary for an effective system of internal control.

D. *Multiple Location Considerations*

Management's consideration of financial reporting risks should generally include all of the company's locations or business units. However, in certain circumstances management may determine that financial reporting risks are adequately addressed by controls which operate centrally, in which case the evaluation approach is similar to that of a business with a single location or business unit. In determining whether the nature and extent of the evidence is sufficient, management should generally consider the risk characteristics of the controls for each financial reporting element, rather than making a single judgment for all controls at a given location. When performing its evaluation of the risk characteristics of the controls identified, management should consider whether there are location-specific risks that might impact the risk that a control might fail to operate effectively. Additionally, there may be pervasive risk factors that exist at a location that cause all controls, or a majority of controls, at that location to be considered higher risk.

IV. Interpretive Guidance: Reporting Considerations

A. *Evaluation of Control Deficiencies*

In order to determine whether a control deficiency, or combination of control deficiencies, is a material weakness requiring disclosure in the company's annual report, management must evaluate the severity of each control deficiency that comes to its attention. Management may not disclose that it has assessed ICFR as effective if there is one or more control deficiencies determined, individually or collectively, to be a material weakness in ICFR as of the end of the fiscal year. Multiple control deficiencies affecting the same financial statement amount or disclosure, that may individually be less severe than a material misstatement, will constitute a material weakness if considered together there is a reasonable possibility that a material misstatement to the financial statements would not be prevented or detected in a timely manner. Therefore, management should evaluate individual control deficiencies that affect the same financial statement amount or disclosure, and the magnitude of the potential misstatement resulting from the deficiency or deficiencies. The following risk factors affect whether there is a reasonable possibility that a deficiency or combination of deficiencies, will result in a misstatement of a financial statement:

- The nature of the financial reporting involved (e.g., suspense accounts and related party transactions involve greater risk);
- The susceptibility of the related asset or liability to loss or fraud (i.e., greater susceptibility increases risk);
- The subjectivity, complexity, or extent of judgment required to determine the amount involved (i.e., greater subjectivity, complexity, or judgment, like that related to an accounting estimate, increases risk);
- The interaction or relationship of the control with other controls, including whether they are interdependent or redundant;
- The interaction of the deficiencies (i.e., when evaluating a combination of two or more deficiencies, whether the deficiencies could affect the same financial statement amounts or disclosures); and
- The possible future consequences of the deficiency.

The maximum amount that an account balance or total of transactions can be overstated is the recorded amount, while understatements could be larger. In many cases, the probability of a

small misstatement will be greater than the probability of a large misstatement. Several factors affect the magnitude of the misstatement that might result from a deficiency or deficiencies in ICFR including, but not limited to the following:

- The financial statement amounts or total of transactions exposed to the deficiency; and
- The volume of activity in the account balance or class of transactions exposed to the deficiency that has occurred in the current period or that is expected in future periods.

In determining whether a deficiency exists management should evaluate whether the following situations exist and if so whether they represent a material weakness:

- Identification of fraud, whether or not material, on the part of senior management (including the principal executive and financial officers signing the company's certifications as required under Section 302 of Sarbanes Oxley as well as any other members of senior management who play a significant role in the company's financial reporting process).
- Restatement of previously issued financial statements to reflect the correction of a material misstatement.
- Identification of a material misstatement of the financial statements in the current period in circumstances that indicate the misstatement would not have been detected by the company's ICFR.
- Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.

If management determines that the deficiency or combination of deficiencies might prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP, then management should treat the deficiency, or combination of deficiencies, as an indicator of a material weakness.

B. *Expression of Assessment of Effectiveness of ICFR by Management*

Management should disclose an unqualified assessment of the effectiveness of ICFR. In addition, if a material weakness exists, management may not state that controls are effective. However, management may state that controls are ineffective for specific reasons.

C. *Disclosures about Material Weakness*

Given the significance of the disclosure requirements surrounding material weaknesses, companies should consider going beyond simply stating their material weaknesses and include:

(1) the nature of any material weakness;

(2) its impact on the company's financial reporting and ICFR; and

(3) management's current plans, if any, or actions already undertaken, for remediating the material weakness.

The goal underlying all disclosure in this area is to provide an investor with disclosure and analysis that goes beyond describing the mere existence of a material weakness. There are many

different types of material weaknesses and many different factors that may be important to the assessment of the potential effect of any particular material weakness. While management is required to conclude and state in its report that ICFR is ineffective when there are one or more material weaknesses, companies should also consider providing disclosure that allows investors to understand the cause of the control deficiency and to assess the potential impact of each particular material weakness. Disclosure will be more useful to investors if management differentiates the potential impact and the importance to the financial statements of the identified material weaknesses, including distinguishing those material weaknesses that may have pervasive impact on ICFR from those material weaknesses that do not.

D. *Impact of a Restatement of Previously Issued Financial Statements on ICFR*

When a material misstatement of previously issued financial statements is discovered, a company is required to restate those financial statements. However, the restatement of financial statements does not, by itself, necessitate that management consider the effect of the restatement on the company's prior conclusion related to the effectiveness of ICFR. Although there is no requirement for management to reassess or revise its conclusion related to the effectiveness of ICFR, management should consider whether its original disclosures are still appropriate and should modify or supplement its original disclosure to include any material information that is necessary for such disclosures not to be misleading in light of the restatement. The company should also disclose any material changes to ICFR, as required by Item 308(c) of Regulation S-K.

E. *Inability to Assess Certain Aspects of ICFR*

In certain circumstances, management may encounter difficulty in assessing certain aspects of its ICFR. For example, management may outsource a significant process to a service organization and determine that evidence of the operating effectiveness of the controls over that process is necessary. The SEC's disclosure requirements state that management's annual report on ICFR must include a statement as to whether or not ICFR is effective and do not permit management to issue a report on ICFR with a scope limitation. Therefore, management must determine whether the inability to assess controls over a particular process is significant enough to conclude in its report that ICFR is not effective.

V. Amendments to Exchange Act Rules 13a-15(c) and 15d-15(c)

Exchange Act Rules 13a-15(c) and 15e-15(c) require the management of each issuer subject to the Exchange Act requirements, other than a registered investment company, evaluate the effectiveness of the issuers ICFR as of the end of each fiscal year. In conjunction with the interpretive guidance, the SEC adopted amendments to Rules 13a-15(c) and 15d-15(c) to provide a safe harbor for companies that conduct an evaluation in accordance with the interpretive guidance. More specifically, the amendments state that an evaluation that complies with the interpretive guidance will satisfy the annual evaluation requirement in Rules 13s-15(c) and 15d-15(c).

According to the SEC, the amendment should not cause confusion. The interpretive guidance states that compliance with the guidance is voluntary. Many companies that are already in compliance with section 404 have established an ICFR evaluation process that may differ from the approach described in the interpretive guidance. There is no requirement for such companies to alter their procedures in order to align with the interpretive guidance.

VI. Amendments to Rules 1-02/ 2-02 of Regs. S-X and Item 308 of Regs. S-B and S-K

Section 404(b) of SOX requires the auditor to "attest to, and report on, the assessment made by the management of the issuer." The SEC has adopted amendments to the rules implementing section 404(b) of SOX. In order to more effectively communicate the auditor's responsibility in relation to management's assessment, the SEC has amended Rule 2-02(f) to require the auditor to express an opinion directly on the effectiveness of ICFR. The rule no longer requires that the auditor express an opinion regarding management's assessment of the effectiveness of ICFR. Additionally, in light of comments to the proposed amendments, the SEC determined that reference to the "attestation report on management's assessment of internal control over financial reporting" would be confusing. Consequently, Rules 1.02(a)(2), Rule 2-02(f), and Rule 2-02(t) of Regulation S-X and item 308 of Regulations S-B and S-K will refer to the auditor's report as an "attestation report on internal control over financial reporting".

VII. Material Weakness: Rule 12b-2 of Exchange Act and Rule 1-02 of Reg. S-X

Material weakness is an integral term associated with SOX and the SEC's implementing rules. Therefore, the SEC deemed it appropriate to amend Rule 12b-2 of the Exchange Act and Rule 1-02 of Regulation S-X to define the term material weakness as: "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 SEC anticipates that the Public Company Accounting Oversight Board's auditing standards will be aligned with the aforementioned definition of material weakness.

VIII. Definition of a Significant Deficiency: Request for Comment

Under the rules implementing Section 302(a) of SOX, management must communicate significant deficiencies to the audit committee and external auditors. The SEC proposed amending Exchange Act Rule 12b-2 and Rule 1-02 of Regulation S-X to define the term significant deficiency to mean "a deficiency, or combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the registrant's financial reporting."

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If you have any questions about the issues addressed in this memorandum or if you would like a copy of any of the materials mentioned, please do not hesitate to call or e-mail Jonathan I. Mark at (212) 701-3100 or jmark@cahill.com; or John Schuster at 212-701-3323 or jschuster@cahill.com.

Annex A

Amend §240.13a-15 by revising paragraph (c) to read as follows:
§240.13a-15 Controls and procedures.

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(c) The management of each such issuer, that either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Act (15 U.S.C. 78m(a) or 78o(d)) for the prior fiscal year or previously had filed an annual report with the Commission for the prior fiscal year, other than an investment company registered under section 8 of the Investment Company Act of 1940, must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, the effectiveness, as of the end of each fiscal year, of the issuer's internal control over financial reporting. The framework on which management's evaluation of the issuer's internal control over financial reporting is based must be a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment. Although there are many different ways to conduct an evaluation of the effectiveness of internal control over financial reporting to meet the requirements of this paragraph, an evaluation that is conducted in accordance with the interpretive guidance issued by the Commission in Release No. 34-55929 will satisfy the evaluation required by this paragraph.

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12. Amend §240.15d-15 by revising paragraph (c) to read as follows:
§240.15d-15 Controls and procedures.

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(c) The management of each such issuer, that either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Act (15 U.S.C. 78m(a) or 78o(d)) for the prior fiscal year or previously had filed an annual report with the Commission for the prior fiscal year, other than an investment company registered under section 8 of the Investment Company Act of 1940, must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, the effectiveness, as of the end of each fiscal year, of the issuer's internal control over financial reporting. The framework on which management's evaluation of the issuer's internal control over financial reporting is based must be a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment. Although there are many different ways to conduct an evaluation of the effectiveness of internal control over financial reporting to meet the requirements of this paragraph, an evaluation that is conducted in accordance with the interpretive guidance issued by the Commission in Release No. 34-55929 will satisfy the evaluation required by this paragraph.

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