MEMORANDUM

TO: Senior Partners, *Cariola Diez Perez-Cotapos*

FROM: Paul Cain, Intern, *Cariola Diez Perez-Cotapos*

DATE: July 30, 2008

RE: The U.S.'s Sarbanes-Oxley Act of 2002

INTRODUCTION

The new millennium brought vast changes to the United States' securities markets and the operating controls of publicly-held companies trading in the U.S. Around the turn of the century, corporate fraud and accounting scandals in the U.S. deeply hurt stock market investors' confidence and forced the bankruptcy of a few large corporations, including Enron (2001), Arthur Andersen (2002), Adelphia (2002), Peregrine Systems (2002), and WorldCom (2002). These failures resulted in immense losses of employee retirement funds, jobs, and investment capital, further weakening investors' faith in publicly-traded companies.

Finding the disclosure and reporting requirements of the Securities Act of 1933[1] and the Securities Exchange Act of 1934[2] inadequate, the United States Congress responded to investors' concerns with the Sarbanes-Oxley Act of 2002 (SOX).[3] The namesake of its congressional sponsors Senator Paul Sarbanes and Representative Michael Oxley, the House of Representatives and the Senate approved SOX with votes of 423-3 and 99-0, respectively. President George W. Bush signed SOX into U.S. federal law on July 30, 2002, stating that the legislation was "the most far reaching reforms of American business practices since the time of Franklin Delano Roosevelt."[4]

Substantively, SOX imposes "strict levels of corporate governance on U.S. corporations and foreign companies listing on U.S. stock markets or that sell securities to groups of private U.S. investors."[5] In order to comply with SOX, directors on companies' boards must be

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[1] *See* U.S.C. § 77a. (2004).
[2] *See id.* § 78a.
[3] *See generally* Sarbanes-Oxley Act of 2002, Pub. L. 107-204, 116 Stat. 745 (codified as amended in 15 U.S.C. §§ 7201-7266 (2006) and scattered sections of 11, 18, 28, and 29 U.S.C.), *available at* http://www.pcaob.org/About_the_PCAOB/Sarbanes_Oxley_Act_of_2002.pdf [hereinafter SOX]. The Sarbanes-Oxley Act of 2002 is also known as the *Public Company Accounting Reform and Investor Protection Act of 2002* and is commonly called "SOX," "the SOA," or "Sarbox."
[4] Elisabeth Bumiller, Bush Signs Bill Aimed at Fraud in Corporations, *The New York Times*, A1, July 31, 2002.
[5] Mary A. Dempsey, *In the Crosshairs*, LatinFinance (March 2005).

completely independent; directors who violate the law face large fines and criminal prosecution.[6] Under SOX, companies must meet more stringent accounting standards, while senior management must sign off on financial results reports and are held personally liable for violations.[7]

THE SEC: REGULATION AND RULEMAKING

The Securities and Exchange Commission (SEC) is the federal regulatory agency charged with administering SOX and six other major U.S. securities laws.[8] It is the SEC's responsibility to "interpret federal securities laws; issue new rules and amend existing rules; oversee the inspection of securities firms, brokers, investment advisors, and ratings agencies; oversee private regulatory organizations in the securities, accounting, and auditing fields; and coordinate U.S. securities regulation with federal, state, and foreign authorities."[9]

The rulemaking function of the SEC is an especially important one, as it is "the *process* by which federal agencies *implement legislation* passed by Congress and signed into law by the President."[10] Statutes are broadly drafted and usually establish only basic principles and objectives that are not reactive to the continuous changes in the securities markets.[11] Specific circumstances that are unaddressed in a statute's language, along with changes in the securities markets (technological advances, size expansions, and new products and services), make rulemaking necessary to ensure that Congress's intent for a statute is carried out.[12]

In order to ensure compliance with the SEC's interpretations of SOX and other U.S. securities laws, it is imperative to constantly monitor the SEC's ever-changing rules. The SEC typically employs a two- or three-step process in making or amending rules:

(1) The first step of "***concept release***" is optional and is used only if a problem is especially unique or complicated. The *concept release* is released by the SEC to gather feedback from the public on which, if any, regulatory approach is appropriate

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[6] *See* Dempsey, *supra* note 5.
[7] *Id.*
[8] The Securities Act of 1933, the Securities Exchange Act of 1934, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisors Act of 1940, and the Credit Agency Reform Act of 2006.
[9] The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation, *found at* http://sec.gov/about/whatwedo.shtml (last visited July 1, 2008).
[10] *Id.* (emphasis added).
[11] *See id.*
[12] *See id.*

in addressing the problem. The *concept release* contains a description of the area of interest, the SEC's concerns about the area or issue, and several different approaches in addressing the problem. The *concept release* concludes with a series of questions seeking the views of the public on the issue, the answers to which the SEC takes into consideration when determining what approach, if any, to use in creating a rule.[13]

(2) The "***rule proposal***" is the next step following the *concept release*, and is the SEC's mandatory starting point for the creation or amendment of rules that address issues that are not especially unique or complicated. The *rule proposal* is an actual proposed rule which contains detailed objectives and the methods for achieving them, and is available for public review and comment for 30 to 60 days. As with a *concept release*, **public comment** on the *rule proposal* **is considered vital to the formulation of a final rule**. [14]

(3) The final step the SEC uses in amending or creating a rule is appropriately named "***rule adoption***." At the *rule adoption* stage, the five Commissioners of the SEC consider the public feedback received during the *rule proposal* stage and seek to agree on the specifics of a *final rule*. If a final measure is "adopted by vote of the full Commission, it becomes part of the official rules that govern the securities industry."[15]

<u>DEFINITION OF "*ISSUER*" UNDER SARBANES-OXLEY</u>

The Sarbanes-Oxley Act of 2002 (SOX) defines "***issuers***" as "all types of registrants that file disclosure documents with the SEC, including all public companies in the United States and all non-U.S. companies having securities listed on a U.S. exchange or traded in NASDAQ."[16] There are three basic ways in which an entity may be considered an "issuer" for purposes of SOX:

(1) A company which has securities registered under Section 12 of the Securities Exchange Act of 1934,[17] or

[13] *See* The Investor's Advocate, *supra* note 9.
[14] *See id.*
[15] *Id.*
[16] JOHN T. BOSTELMAN, THE SARBANES-OXLEY DESKBOOK, § 3:2 (Release No. 14 2007).
[17] *See* 15 U.S.C. § 78*l*.

(2) A company which is required to file reports under Section 15(d) of the Securities Exchange Act of 1934,[18] or

(3) A company that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933, and that it has not withdrawn.[19]

THE ELEVEN TITLES OF SARBANES-OXLEY

The Sarbanes-Oxley Act of 2002 is divided into eleven titles and a section of definitions. Each title contains anywhere from one to nine sections, with a total of fifty-six sections. The following explanations provide a very basic overview of those sections of SOX which are considered the *most* relevant for purposes of this memorandum.

Title I: Public Company Accounting Oversight Board (PCAOB), §§ 101-109

Title I establishes the five-member Public Accounting Oversight Board (PCAOB), a private-sector, non-profit corporation that oversees the auditors of public companies.[20] The PCAOB exercises jurisdiction over registered public accounting firms (RPAFs) and associated persons, but "does not regulate accounting firms that perform services only for private companies."[21] The PCAOB's duties are to-

(1) register public accounting firms that prepare audit reports for issuers;

(2) create rules for auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports for issuers;

(3) conduct inspections, investigations, and disciplinary proceedings concerning RPAFs, and, when justified, impose appropriate sanctions upon such entities;

(4) perform other duties that promote high professional standards among and improve the quality of audit services offered by RPAFs, in order to protect investors and further the public interest;

(5) enforce compliance with SOX, the rules of the PCAOB, professional standards, and the securities laws relating to the preparation and issuance of audit reports by RPAFs.[22]

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[18] *See* 15 U.S.C. § 78o(d).
[19] *See* § 77a.
[20] PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD, PCAOB STRATEGIC PLAN: 2008-2013, at 3 (2008), http://www.pcaob.com/About_the_PCAOB/Strategic_Plan.pdf.
[21] BRIGHTON, JR., *supra* note 16, at 618.
[22] *See* SOX § 101.

Title II: Auditor Independence, §§ 201-209

Title II established standards for external auditor independence in order to limit conflicts of interest. This Title specifically prohibits external auditors from providing any non-audit services to an issuer while an external audit is being performed, including-

(1) bookkeeping or other services related to the accounting records or financial statements of the audit client;

(2) financial information systems design and implementation;

(3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;

(4) actuarial services;

(5) internal audit outsourcing services;

(6) management functions or human resources;

(7) broker or dealer, investment advisor, or investment banking services;

(8) legal services and expert services unrelated to the audit; and

(9) any other service that the PCAOB determines, by regulation, is impermissible.[23]

The PCAOB does have authority to exempt issuers or audit firms from these prohibitions on a case-by-case basis, but "such exemptions would probably be restricted to situations where the discontinuation of an auditor's non-audit services would result in extreme hardship to the company."[24] An external auditor may perform a non-audit service that is not specifically prohibited by Title II for an issuer during an external audit, such as tax services, but the service must first be preapproved by the issuer's audit committee.[25]

Title III: Corporate Responsibility, §§ 301-308

(1) § 301. Public company audit committees.

"Congress realized before the enactment of SOX that many problems were due to 'close ties between audit committee members and management.'"[26] This section is intended to create separation between an issuer's auditors and the issuer's management, thereby removing a possible area of conflicting interests. An issuer's audit committee, acting as a committee of the issuer's board of directors, must be comprised of "***independent***" members of the issuer's board.

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[23] *See* SOX § 201.
[24] BRIGHTON, JR., *supra* note 16, at 621.
[25] *See* SOX §§ 201, 202.
[26] William A. Nelson, *Sarbanes-Oxley Act of 2002: Are Multi-National Corporations Unduly Burdened?* 5 (The Berkeley Electronic Press Legal Series, Paper No. 1127, 2006) *available at* http://law.bepress.com/cgi/viewcontent.cgi?article=5312&context=expresso (internal quotation marks omitted).

To be considered *independent*, members of an audit committee must not accept any consulting, advisory, or other compensatory fee, and they must not be affiliated with the issuer or any of its subsidiaries. The audit committee may employ issuer-compensated independent counsel and other advisors that it deems necessary in carrying out its functions.

Any registered public accounting firm performing an audit on the issuer reports directly to the audit committee, who is entirely responsible for the appointment, compensation, and oversight of the auditor. Any accounting- or audit-related complaints that the issuer receives are to be forwarded to the audit committee, who then must retain and resolve such problems. The audit committee is also responsible for resolving anonymous and confidential concerns voiced by the issuer's employees relating to questionable accounting or auditing matters.[27]

(2) § 302. Corporate responsibility for financial reports.

The principal executive and financial officers of an issuer (typically the CEO and CFO) are required certify that the issuer's SEC-required periodic financial statements within forms 10-Q, 10-K, 20-F, and 40-F, and any amendments to such reports, are truthful and contain no material misstatements; the statement gives assurances that the company's financial reporting and disclosure procedures are adequate and in compliance with SEC rules and regulations.[28] Under this section, **an issuer's executive officers are required to certify that**:

(a) the signing officer has reviewed the report;

(b) based on the officer's knowledge, the report is materially accurate and all financial information in the report is for the periods presented in the report;

(c) the signing officers

- **(i)** are responsible for establishing and maintaining the issuer's internal controls, and have evaluated the effectiveness of such controls as of the date within 90 days prior to the report,
- **(ii)** have designed the issuer's internal controls to ensure that such officers are informed of all material information relating to the issuer and its subsidiaries, particularly during the time in which the reports are being prepared,

[27] *See* SOX § 301.
[28] *See* NELSON, *supra* note 26, at 4-7.

(iii) have presented in the report their conclusions about the effectiveness of the their internal controls based on their evaluation as of that date, and

(iv) have indicated in the report, subsequent to the date of their review of internal controls, whether or not there were any significant changes in internal controls or any other factors that could affect the internal controls;

(d) the signing officers have disclosed to the issuer's audit committee and auditors

(i) all significant deficiencies in the design or operation of internal controls which could lead to incorrect financial data in the report and

(ii) any fraud, regardless of materiality, that involves management or any other employees who have a significant role in the issuer's internal controls.[29]

(3) § 306. Insider trades during pension fund blackout periods.

This section, which applies only to issuers that maintain individual account plans, prohibits an issuer's directors or executive officers from acquiring or transferring any of the issuer's non-exempt equity securities during any "***blackout period***." A *blackout period* is (with a number of exceptions): any period of three or more consecutive business days during which at least half of the issuer's U.S. individual account plan participants or beneficiaries are not allowed to trade the issuer's stock that is within their plans. The issuer must give the participants at least thirty days notice prior to a blackout period.[30]

(4) § 307. Rules of professional responsibility for attorneys.

Duty to report evidence of a material violation. "If an attorney, *appearing and practicing before the Commission* in the representation of an issuer, becomes aware of *evidence of a material violation* by the issuer or an officer, director, employee, or agent of the issuer," the attorney must report such evidence "to the issuer's chief legal officer (or the equivalent thereof) or to both the issuer's chief legal officer and its chief executive officer (or the equivalents thereof)."[31] Next, the chief legal officer (CLO) or CEO must conduct a reasonable inquiry to determine if the reported material violation has occurred, is occurring, or is about to occur. If the CLO or CEO concludes that there is no material violation, he must notify the reporting attorney; otherwise, the CLO or CEO must take all reasonable steps to cause the issuer to adopt remedial

[29] *See* SOX § 302.
[30] *See id.* § 306.
[31] 17 C.F.R. § 205.3(b) (2008).

measures in order to stop or prevent an ongoing or future violation, and to rectify and minimize the possibility of recurrence of a past violation.[32]

However, if the CLO or CEO does not appropriately respond to the reporting attorney's concerns within in a reasonable time, the reporting attorney has a duty to initiate what has been termed "up the ladder" reporting: he must continue reporting up the issuer's corporate hierarchy (to its audit committee, to another committee of its board of directors, or to its board of directors itself) until he receives an adequate response to his concerns.[33] If "the SEC's Division of Enforcement encounters an issuer's violation of the securities laws, it will now likely look to see whether there was" an attorney "who (A) knew (or should have known) of the activities in question (B) was 'appearing' 'before the Commission' 'with respect to the issuer' and (C) failed to initiate a process in compliance with the extraordinarily prescriptive mandates of the new rules – as the Division of Enforcement interprets them."[34] If a lawyer who was required to initiate the reporting process failed to do so, the Division of Enforcement "will argue that proceedings against the lawyer are appropriate."[35]

Attorneys practicing outside the United States are not required to comply with the requirements of section 205 of the Code of Federal Regulations "to the extent that such compliance is prohibited by applicable foreign law."[36] A <u>non-appearing foreign attorney</u> is not required to follow SOX's provisions; this type of attorney is defined as one "(1) Who is admitted to practice law in a jurisdiction outside of the United States; (2) Who does not hold himself or herself out as practicing, and does not give legal advice regarding, United States federal or state securities or other laws (except as provided in paragraph (j)(3)(ii) of this section); and (3) Who:

(i) Conducts activities that would constitute appearing and practicing before the Commission only incidentally to, and in the ordinary course of, the practice of law in a jurisdiction outside of the United States; or

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[32] *See id.*
[33] *See* SOX § 307.
[34] Simon M. Lorne, *An Issue- Annotated Version of the SOX Rules for Lawyer Conduct*, *in* PREPARATION OF ANNUAL DISCLOSURE DOCUMENTS 2008, at 227 (PLI Corp. Law & Practice, Course Handbook Series No. 14471, 2008).
[35] *Id.*
[36] 17 C.F.R. § 205.6(d).

(ii) Is appearing and practicing before the Commission only in consultation with counsel, other than a non-appearing foreign attorney, admitted or licensed to practice in a state or other United Stated jurisdiction."[37]

There is one exception to this provision, which can cause any attorney, including a non-appearing foreign attorney, to be regarded as appearing and practicing before the Commission. This exception occurs where an attorney acts as a supervisory attorney to a subordinate attorney, and where the subordinate attorney "appears and practices before the Commission in the representation of an issuer," the supervisory attorney is deemed to also appear and practice before the Commission to the same extent as that of the subordinate attorney.[38]

Title IV: Enhanced Financial Disclosures, §§ 401-409

Title IV requires issuers to maintain disclosure controls and procedures "designed to ensure that financial and non-financial information is fully and accurately disclosed on a timely basis."[39]

(1) § 404. Management assessment of internal controls.

An issuer's management must establish and maintain an adequate internal control structure and financial-reporting procedures. The issuer's annual reports must be accompanied by a management report assessing the effectiveness of internal control and a report by the issuer's auditors regarding management's assessment. This section is arguably SOX's most difficult for issuers to comply with, and most of recommendations provided at the end of this memorandum relate to this section.[40]

(2) § 406. Code of ethics for senior financial officers.

An issuer must disclose its code of ethics for senior financial officers in its annual report; if it has not adopted such a code, the issuer must disclose its reasoning for not doing so. An issuer whose code of ethics is not in compliance with this section's requirements may not report that it has a code; any changes made to an issuer's code must be reported.[41]

[37] 17 C.F.R. § 205.2(j).
[38] *Id.* § 205.4(b).
[39] BOSTELMAN, *supra* note 16, § 5:1.
[40] *See* SOX § 404.
[41] *See id.* § 406.

(3) § 409. Real time issuer disclosures.

Issuers are required to "disclose to the public on a rapid and current basis" any "material changes in the financial condition or operations of the issuer, in plain English," which is "necessary or useful for the protection of investors and in the public interest."[42]

Title VIII: Corporate and Criminal Fraud Accountability, §§ 801-807

(1) § 802. Criminal penalties for altering documents.

Any person who knowingly tampers with any information with the intent to obstruct "the investigation or proper administration of any matter within the jurisdiction of any department or agency of the United States"[43] or any bankruptcy case may be fined, imprisoned for up to 20 years, or both. Accountants who audit issuers must maintain all audit or review information for 7 years, starting from the end of the fiscal period in which the audit or review was performed; violators of this provision may be fined, imprisoned for up to 10 years, or both.[44]

(2) § 804. Statute of limitations for securities fraud.

Securities fraud actions must be brought within the earlier of: (a) 2 years after the discovery of the facts constituting the violation or (b) 5 years after a violation.[45]

(3) § 806. Protection for employees of publicly traded companies who provide evidence of fraud.

Employees of issuers who are retaliated against for providing information, assisting in an investigation, or providing information in a proceeding concerning alleged violations of U.S. federal securities laws or anti-fraud laws are "entitled to all relief necessary to make the employee whole,"[46] including reinstatement, back pay, and special damages (which includes attorney's fees, litigation costs, and expert witness fees).[47]

(4) § 807. Criminal penalties for defrauding shareholders of publicly traded companies.

An individual who knowingly attempts to defraud a person in connection with a security or attempts to obtain, through false or fraudulent actions, any money or property in connection with the purchase or sale of any security may be fined, imprisoned for up to 25 years, or both.[48]

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[42] *See* SOX § 409.
[43] SOX § 802.
[44] *See* BOSTELMAN, *supra* note 16, § 15:7.
[45] *See* SOX § 804.
[46] *Id.* § 806.
[47] *See id.*
[48] *See id.* § 807.

Title IX: White-Collar Crime Penalty Enhancements, §§ 901-906

(1) § 902. Attempts and conspiracies to commit criminal fraud offenses.

"[A]ny attempt or conspiracy to commit an offense under chapter 63 of Title 18 of the U.S. Code"[49] (the chapter dealing with mail and wire fraud) is now subject "to the same penalties applicable to the underlying offense."[50]

(2) § 903. Criminal penalties for mail and wire fraud.

"[T]he maximum prison term for both mail and wire fraud is increased from 5 years to 20 years."[51]

(3) § 904. Criminal penalties for violations of the Employee Retirement Income Security Act of 1974.

"[T]he maximum fine for ERISA violations is increased from $5,000 to $100,000 for individuals and from $100,000 to $500,000 for non-individuals. The maximum prison term is also increased from 1 year to 10 years."[52]

(4) § 906. Corporate responsibility for financial reports.

An issuer's CEO and CFO are required to certify that the issuer's periodic "financial statements fully complies with the requirements of section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in the report fairly presents, in all material respects, the financial condition and results of operations of the issuer."[53] An individual who certifies such a statement knowing that the statement does not comport with this section's requirements may be fined up to $1,000,000, imprisoned up to 10 years, or both; an individual who does so willfully may be fined up to $5,000,000, imprisoned up to 20 years, or both.[54]

Title XI: Corporate Fraud and Accountability, §§ 1101-1107

(1) § 1102. Tampering with a record or otherwise impeding an official proceeding.

Anyone who corruptly attempts to tamper with an official proceeding, or information to be used in such a proceeding, may be fined, imprisoned for up to 20 years, or both.[55]

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[49] BOSTELMAN, *supra* note 16, § 27:3.
[50] *Id.*; *see* SOX § 804.
[51] BOSTELMAN, *supra* note 16, § 27:4; *see* SOX § 903.
[52] BOSTELMAN, *supra* note 16, § 27:4; *see* SOX § 904.
[53] BOSTELMAN, *supra* note 16, § 4:9; *see* SOX § 906.
[54] *See* SOX § 906.
[55] *See id.* § 1102.

(2) § 1103. Temporary freeze authority for the Securities and Exchange Commission.

If, during an investigation for violations of Federal securities law by an issuer or one of its affiliated persons, it appears the issuer will make "extraordinary payments" to one of its affiliated persons, the SEC may petition a Federal district court for an order requiring the issuer to escrow those payments in an interest-bearing account for 45 days, subject to an extension of an additional 45 days. If the investigation results in the issuer or one of its affiliated persons being charged with a violation of a Federal securities law before the escrow-order expires, the court may extend the order until the conclusion of any legal proceedings related to the violation.[56]

(3) § 1105. Authority of the Commission to prohibit persons from serving as officers or directors.

The SEC may issue an order permanently prohibiting individuals from serving as officers or directors of issuers, if such individuals have violated securities law antifraud provisions.[57]

(4) § 1106. Increased criminal penalties under Securities Exchange Act of 1934.

"The maximum fine for Exchange Act criminal violations is increased from $1 million to $5 million for individuals and from $2.5 million to $25 million for non-individuals. The maximum prison term is increased from [10] years to [20] years."[58]

(5) § 1107. Retaliation against informants.

An individual who knowingly takes any action harmful to any person, with the intent to retaliate for the person's providing truthful information to a law enforcement officer relating to the possible commission of any Federal offense, may be fined, imprisoned for up to 10 years, or both.[59]

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[56] BOSTELMAN, *supra* note 16, § 4:9; *see* SOX § 1103.
[57] *See* SOX § 1105.
[58] BOSTELMAN, *supra* note 16, § 4:9; *see* SOX § 1106.
[59] *See* SOX § 1107.

RECOMMENDATIONS

I. Internal Control over Financial Reporting (SOX § 404)

A. Introduction

The staff of the SEC regularly issues guidance with the purpose of providing assistance to corporations responsible for complying with SOX's provisions. Found in this guidance is an overarching theme that calls for an approach to internal control procedure and financial reporting that is ***principles-based/objectives-oriented***[60] and ***top-down/risk-based***.[61] This is the perspective that any company undertaking SOX compliance should have. Such an approach allows SOX-covered companies to move away from a mechanistic, "check-the-box" exercise to one that focuses on and devotes resources to the areas of greatest risk.[62]

B. Internal Control Selection

When selecting controls to assess, management should give the most attention to "controls related to those processes and classes of transactions for financial statement accounts and disclosures that are most likely to have a material impact on the company's financial statements."[63] Once high risk areas have been identified, management should select "relevant controls and design appropriate procedures for documentation and testing of those controls."[64] Evaluating the risk-significance of an account or process by using a percentage as a minimum threshold may be a good place to start; however, management's judgment on percentage-based controls should also take qualitative factors into account, in order to "determine if amounts above or below that threshold must be evaluated."[65]

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[60] *See* Office of the Chief Accountant, Office of Economic Analysis, SEC, Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System, at I.C. (July 25, 2003), *available at* http://www.sec.gov/news/studies/principlesbasedstand.htm ("[T]he optimal principles-based accounting standard involves a concise statement of substantive accounting principle where the accounting objective has been incorporated as an integral part of the standard and where few, if any, exceptions or internal inconsistencies are included in the standard. Further, such a standard should provide and appropriate amount of implementation guidance given the nature of the class of transactions or events and should be devoid of bright-line tests. Finally, such a standard should be consistent with, and derive from, a coherent conceptual framework of financial reporting.").

[61] *See* Office of the Chief Accountant, Division of Corporation Finance, SEC, Staff Statement on Management's Report on Internal Control Over Financial Reporting, at 4 (May 16, 2005), *available at* http://www.sec.gov/info/accountants/stafficreporting.htm [hereinafter Staff Statement] ("The assessment of internal control over financial reporting will be more effective if it focuses on controls related to those processes and classes of transactions for financial statement accounts and disclosures that are most likely to have a material impact on the company's financial statements.").

[62] *See* Staff Statement, *supra* note 54, at 5-6.

[63] *Id.* at 6.

[64] *Id.*

[65] *Id.*

In general, management should select accounts for assessment "by focusing on annual and company measures rather than interim or segment measures."[66] Examples of exceptions to this rule include: companies that have "one or two key segments that are driving the business and are material to investors," in which case "management also may want to consider those segment measures to determine the required level of documentation and testing"; or, in limited circumstances, "where interim results drive the business (such as the holiday season for retailers) and are similarly of significant interest to investors."[67] If a deficiency is identified through a control test, management must "measure the significance of the deficiency by using both quarterly and annual measures, also considering segment measures where applicable."[68]

C. Internal Control Testing

Once management has identified the accounts and their related processes that are of a high risk-significance, the focus must turn to "the controls to be tested that are relevant to those processes."[69] Some or all of the many controls "identified for testing during the first year of implementation may, in part, represent individual steps within what may constitute a broader control."[70] In future assessments, management might find it helpful to consider whether previously-identified combinations of controls "individually constitute the actual control that contributes to financial statement assurance."[71] Management should not be focused on identifying, documenting, and testing each individual step involved in a broader control definition; instead, the focus should be on the broad objective of such controls, and testing the effectiveness of the combination of detailed steps in order to meet the broader control objective.[72] From this analysis, management may determine that some steps within a control are not necessary to verify that the overall control is operating effectively, thereby reducing the number of steps and streamlining the internal control process.[73]

With each successive completion of their internal control assessments, management will naturally achieve efficiencies in the design, implementation, and prioritization of control

[66] *See* Staff Statement, *supra* note 54, at 8.
[67] *Id.* at 8 n.15.
[68] *Id.* at 8.
[69] *See id.* at 7.
[70] *Id.*
[71] *Id.*
[72] *See* Staff Statement, *supra* note 54, at 7.
[73] *See id.*

testing.[74] However, for the most efficient and effective assessment of internal control, it is critically important that company personnel and auditors closest to the assessment possess the requisite skills, training, and judgment to make accurate evaluations.[75] These individuals "abilit[ies] to make such assessments in a consistent and sound manner will improve with experience and it is the exercise of judgment which makes the audit a professional responsibility."[76]

D. Multiple Location Considerations

When determining financial reporting risks for a business with multiple locations, management should consider if the risks of control-failure are adequately addressed by controls which operate centrally.[77] If the level of risk is low enough, management may decide to use an "evaluation approach . . . similar to that of a business with a single location or business unit."[78] However, if such risks are of a location-specific nature and the level of uncertainty about their failure is high enough, the situation may require the evaluation of "evidence of the operation of the controls at the individual locations or business units."[79] When deciding whether the nature and extent of evidence at a particular location is sufficient, "management should consider the risk characteristic of the controls for each financial reporting element, rather than making a single judgment for all controls at the location."[80]

E. Evaluating Internal Control Deficiencies

If management determines that a control, or combination of controls, is deficient providing reliable financial information, it must first evaluate the severity of the deficiency, and then classify the deficiency in one of two classes.[81] The less-serious of the two classes is "material weakness," which is "a deficiency, or 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

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[74] *See* Staff Statement, *supra* note 54, at 7.
[75] *See id.*
[76] *Id.*
[77] *See* Interpretive Release: 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, at 32, Securities Act Release No. 33-8810, Exchange Act Release No. 34-55929, 72 Fed. Reg. 35,324, at 35,332 (June 20, 2007), *available at* http://sec.gov/rules/interp/2007/33-8810.pdf [hereinafter Commission Guidance].
[78] Commission Guidance, *supra* note 69, at 32.
[79] *Id.* at 32-33.
[80] *Id.* at 33.
[81] *Id.* at 34.

timely basis."[82] Material weaknesses "must be disclosed in management's annual report on its assessment of the effectiveness of ICFR."[83] The second, more-serious class is the "significant deficiency," defined as "a deficiency, or a 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."[84] Significant deficiencies must be "reported to the company's audit committee and the external auditor pursuant to management's compliance with the certification requirements in Exchange Act Rule 13a-14."[85]

F. Disclosures About Material Weaknesses

In addition to simply stating that a material weakness exists, "companies should also consider including the following in their disclosures: t]he nature of any material weakness, its impact on the company's financial reporting and its IFCR, and management's current plans, if any, or actions already undertaken, for remediating the material weakness."[86] This will allow "investors to understand the cause of the control deficiency and to assess the potential impact of each particular material weakness."[87] "[I]f management differentiates the potential impact and importance to the financial statements of the identified material weaknesses" by "distinguishing those material weaknesses that may have a pervasive impact on ICFR from those material weaknesses that do not," then the "disclosure will be more useful to investors."[88]

II. Private Companies

Although private companies are not required to comply with SOX's provisions, they may want to consider SOX-compliance. If they plan to list on a U.S. market or sell their business, an investor "would pay more for a company where the control environment is very strong. You could rely on the integrity of the financial information," says Tim Hartnett, lead partner at PriceWaterhouseCoopers's Latin American Transaction Services practice in Miami.[89] Hartnett states that if a potential buyer of a company looked into the company's financial reports and found irreconcilable information, a lack of information, or a weak control environment, "you still

[82] Definitions of terms used in Regulation S-X, 17 C.F.R. § 210.1-02(a)(4) (2008).
[83] Commission Guidance, *supra* note 69, at 34.
[84] § 210.1-02(a)(4).
[85] Commission Guidance, *supra* note 69, at 34.
[86] *Id.* at 38-39.
[87] *Id.* at 39.
[88] *Id.*
[89] Dempsey, *supra* note 5.

may buy the company. But you would pay much less."[90] If private companies ensure SOX compliance, buyers will be much less concerned about the future costs of compliance eating into the bottom line, SEC-imposed fines for future non-compliance, and corporate fraud or earnings restatements.

Additionally, private companies that do not plan on listing on a U.S. market or selling may also find benefits in complying with SOX.[91] "As companies in the U.S. are having to monitor more closely what they are doing overseas, they will probably begin to look more closely at what their providers are doing as well," says John Zempko, senior program director for Latin America and the Caribbean at the Center for International Private Enterprise.[92] Zemko concludes that private companies who are providers to SOX-covered companies may find that their own SOX-compliance gives them a competitive advantage over their competition "by providing American partners with a greater level of compliance with U.S. laws and practices."[93]

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[90] Dempsey, *supra* note 5.
[91] *Id.*
[92] *Id.*
[93] *Id.*