Audit Analytics™

Briefing - Disclosure Controls

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The Analysis of Section 302 Disclosure Control Filings

Section 302 of Sarbanes-Oxley Act of 2002 ("SOX"), and the attendant rules promulgated by the SEC, created new corporate duties and filings for public registrants. In addition to prescribed certifications, the CEO and CFO of a company/registrant must provide in each quarterly and annual report a conclusion of their separate evaluations of the registrant's "Disclosure Controls and Procedures." In short, the CEO and CFO must state in the reports (each read by an AuditAnalytics professional) whether the disclosure controls are effective or ineffective. However, as of January 2006, the language and terms used to express a 302 Disclosure Control evaluation are not yet uniform.

Current Issues with the Section 302 Disclosure Control Filings

In contrast, a Section 404 evaluation of "Internal Controls for Financial Reporting" (and that portion of a 302 evaluation that assesses such internal controls) uses well-defined financial terms. Under Section 404, terms like "Adverse", "Material Weakness" and "Significant Deficiency" are well documented and understood. Although professional discretion must be exercised in determining which term applies to a specific shortcoming, when the judgment is made, others readily understand the extent and consequences of the weakness. For example, under Section 404, an un-remediated Material Weakness always translates into an adverse opinion with respect to the Internal Controls over Financial Reporting.

Under Section 302, no such parallel terms of well-defined gradation, and interdependent consequences, exist. Although each registrant is required to report whether their Disclosure Controls are "effective" or "ineffective," many fail to do so unequivocally. Most registrants use qualifying language in their filings such as, the following: "reasonably effective", "effective, however", "effective, subject to", "effective, however our auditors have disclosed material weaknesses…" While many Section 302 issuers describe their Disclosure Controls deficiencies by using terms of art outlined in PCAOB Standard number 2 (e.g., Material Weakness, which governs 404 disclosures), many do not.

This issue is also exacerbated by the fact that Disclosure Control filings have been required to be reported since August 2002 while guidance on the proper expression of an assessment has been slow to evolve. As a result, much of the wording and characterizations contained within Disclosure Control filings have changed over the past years. With the advent of PCAOB Standard Number 2 and the additional guidance given by the SEC, such disclosures have recently become more consistent. Nevertheless, there remain occurrences where registrants report a material weakness in Disclosure Controls while failing to report that their Disclosure Controls are ineffective. Furthermore, a registrant can report in their opinion that Disclosure Controls are effective, but also report that their auditor informed them that they have a material weakness.

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Current Issues with the Section 302 Disclosure Control Filings *(continued)*

As a result of these inconsistencies in the reporting of Disclosure Controls by registrants, our database has been designed to allow the analyst to capture multiple (and apparently irreconcilable) declarations:

1. a registrant indicates an ineffective assertion, but does not disclose a Material Weakness, significant deficiency or other opinion;
2. a registrant indicates an effective assertion while also disclosing a material weakness, significant deficiency or other weakness;
3. a registrant indicates an effective assertion, but qualifies it in some way or provides additional disclosures to the reader about their controls.

The AuditAnlaytics.com interface offers several different ways to deal with the needs of the researcher/analyst. A researcher may limit a search to a particular set of four categories of deficiency by selecting one or more designation box next to the following types of deficiency categories: Accounting Rule (GAAP/FASB) Application Failure; Financial Fraud, Irregularities and Misrepresentations; Errors in Accounting and Clerical Applications; Other Disclosure Control Weakness. Each of the four deficiency categories in turn has an adjacent drop-down box containing a detailed list of "Reasons" for such a deficiency, thereby allowing an even more distilled search. For example, someone may be looking to determine how many Disclosure Control deficiencies were associated with FAS 109 Tax issues. To obtain such a list, one would leave blank all the designation boxes (e.g., Material Weakness, Other Deficiencies, Effective, etc.) except for the designation box adjacent to Accounting/GAAP failures. The researched would click the Accounting/GAAP failure box and then select FAS 109 from the "Reason" drop-down box. If one is looking to ascertain how many registrants filed ineffective assertions but not Material Weakness assertions, then one would select "No" in the "Management – disclosure" drop-down box while leaving the "Material Weakness" box empty. Also, to allow more advanced searches, we have include a text search of all of the Section 302 disclosures (not the Certifications) to aid targeted inquiries. All these abilities allow for a very flexible and efficient analysis of most permutations of interest.

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