



Federal Register

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Part IV

Securities and Exchange Commission

**17 CFR Parts 210 and 240
Definition of a Significant Deficiency;
Proposed Rule**

SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 210 and 240

[Release Nos. 33–8811; 34–55930; File No. S7–24–06]

RIN 3235–AJ58

Definition of a Significant Deficiency

AGENCY: Securities and Exchange Commission.

ACTION: Request for additional comment.

SUMMARY: We are requesting additional comment on the definition of the term “significant deficiency.” Because this term is used in the Commission’s rules implementing Section 302 and Section 404 of the Sarbanes-Oxley Act, we believe that a definition of this term should also be in the Commission’s rules, in addition to being in the auditing standards.

DATES: *Comment Date:* Comments should be received on or before July 18, 2007.

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments

- Use the Commission’s Internet comment form (<http://www.sec.gov/rules/proposed.shtml>); or
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7–24–06 on the subject line; or
- Use the Federal eRulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

Paper Comments

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549–1090.

All submissions should refer to File Number S7–24–06. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission’s Internet Web site at (<http://www.sec.gov/rules/proposed.shtml>). Comments are also available for public inspection and copying in the Commission’s Public Reference Room, 100 F Street, NE., Washington, DC 20549. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: N. Sean Harrison, Special Counsel, Division of Corporation Finance, at (202) 551–3430, or Josh K. Jones, Professional Accounting Fellow, Office of the Chief Accountant, at (202) 551–5300, U.S. Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549.

SUPPLEMENTARY INFORMATION: We are soliciting additional comment on Rule 12b–2¹ under the Securities Exchange Act of 1934 (the “Exchange Act”)² and Rule 1–02³ of Regulation S–X.⁴

I. Background

The Commission’s rules implementing the requirements of the Sarbanes-Oxley Act of 2002 (“Sarbanes-Oxley”)⁵ require management to disclose to both the audit committee and the external auditor all “material weaknesses” and “significant deficiencies” identified based upon management’s evaluation.⁶ In adopting rules to implement these sections of Sarbanes-Oxley, the Commission indicated that these terms had the same meaning for purposes of the Commission’s rules as they had under generally accepted auditing standards and therefore, did not specifically define them. Subsequent to the Commission’s adoption of rules implementing Sections 302 and 404 of Sarbanes-Oxley, the Public Company Accounting Oversight Board (“PCAOB”) adopted Auditing Standard No. 2,⁷ which revised these definitions. Since the Commission’s intention in the Adopting Release was to refer to the definition used by auditors of public companies, the Commission staff issued an interpretation indicating that the PCAOB’s definition of these terms would apply to the Section 404 rules issued by the Commission.⁸

More recently, as part of the Commission’s project providing more guidance to management on completing its evaluation and assessment of internal control over financial reporting

(“ICFR”) in accordance with Section 404 of Sarbanes-Oxley, the Commission initially sought comment on both the terms “significant deficiency” and “material weakness” in its concept release on ICFR requirements,⁹ and then proposed and adopted a definition for only the term “material weakness.”¹⁰ As part of that rulemaking process, commenters pointed out that while the December proposing release¹¹ referenced significant deficiencies, the Commission did not include a definition of significant deficiency within the proposal.¹² Certain commenters indicated that the Commission should include a definition of significant deficiency in the Interpretive Guidance.¹³

II. Discussion

As part of the Interpretive Guidance rulemaking process, the Commission determined that it was appropriate for the Commission to include in its rules definitions for certain integral terms associated with the Commission’s rules implementing Sarbanes-Oxley. Further, in light of the comments received in response to the proposed Interpretive Guidance, and because Commission rules implementing Section 302(a) of Sarbanes-Oxley require that management communicate significant deficiencies to the audit committee and the external auditors, the Commission has decided to solicit additional comment on a definition for “significant deficiency.” As a result, we are soliciting additional comment on amending Exchange Act Rule 12b–2 and Rule 1–02 of Regulation S–X to define the term.

The purpose of management’s obligations with respect to significant deficiencies within the Commission’s rules is to disclose those matters relating to ICFR that are of sufficient importance that they should be reported to the external auditor and to the audit committee so that these parties can more effectively carry out their respective responsibilities with regard to the company’s financial reporting, but which do not require disclosure to investors. Including a definition of significant deficiency in Commission rules, in combination with the

¹ 17 CFR 240.12b–2.

² 15 U.S.C. 78a *et seq.*

³ 17 CFR 210.1–02.

⁴ 17 CFR 210.1–01 *et seq.*

⁵ 15 U.S.C. 7262.

⁶ Release No. 33–8238 (Jun. 5, 2003) [68 FR 36636, Jun. 18, 2003], referred to herein as the “Adopting Release.”

⁷ *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements.*

⁸ See, for example, question 13 of Office of the Chief Accountant and Division of Corporation Finance: *Management’s Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports Frequently Asked Questions* (revised Oct. 6, 2004), available at <http://www.sec.gov/info/accountants/controlfaq1004.htm>.

⁹ Release No. 34–54122 (Jul. 11, 2006) [71 FR 40866, Jul. 18, 2006] available at <http://www.sec.gov/rules/concept/2006/34-54122.pdf>.

¹⁰ Release No. 34–55929 (Jun. 20, 2007), and referred to herein as the “Interpretive Guidance.”

¹¹ Release Nos. 33–8762; 34–54976 (Dec. 20, 2006) [71 FR 77635, Dec. 27, 2006].

¹² See, for example, letters from Cardinal Health, Inc. (Cardinal), Edison Electric Institute, and Protiviti.

¹³ See, for example, letters from Cardinal and Protiviti.

definition of material weakness, will provide a useful complement to the Commission's Interpretive Guidance by enabling management to refer to Commission rules and guidance for information on the meaning of these terms rather than the referring to the auditing standards.

In developing the definition, we considered comments received in response to the PCAOB's proposed auditing standard for audits of internal control over financial reporting. In its proposed auditing standard, the PCAOB proposed to define significant deficiency as "a control deficiency, or combination of control deficiencies such that there is a reasonable possibility that a significant misstatement of the company's annual or interim financial statements will not be prevented or detected."¹⁴ Further, a significant misstatement was defined as "a misstatement that is less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting." In response to the comments received on their proposal, the PCAOB decided to modify their proposed definition in order to focus the auditor on the communication requirement surrounding the term "significant deficiency" and to provide clarity that auditors are not required to scope their audits to search for deficiencies that are less severe than a material weakness. We believe that the focus of the term "significant deficiency" should be the underlying communication requirement that results between management, audit committees and independent auditors. As such, we are soliciting comment on a definition that focuses squarely on matters that are important enough to

merit attention by those responsible for oversight of the company's financial reporting. Significant deficiency would be 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 a registrant's financial reporting."¹⁵

The framework for the definition of significant deficiency varies from that recently adopted for "material weakness." Unlike the term "material weakness," we do not believe it is necessary for the definition of significant deficiency to explicitly include a likelihood component (that is, reasonable possibility) and that focusing on matters that are important enough to merit attention will allow for sufficient and appropriate judgment for management to determine the deficiencies that should be reported to the auditor and the audit committee.

III. Request for Comment

We request additional comment on defining the term "significant deficiency." In addition to general comment, we encourage comments to address the following specific questions:

- Would the definition of a "significant deficiency" facilitate more effective and efficient certification of quarterly and annual reports if it were defined as discussed above?
- Conversely, should the definition of "significant deficiency" include a likelihood component or other specific criteria? If so, should we align such a definition with the PCAOB's auditing standard, and how?
- We do not anticipate that the definition will impact the amount of

time it takes for management to evaluate whether identified deficiencies are significant deficiencies, nor do we anticipate that this definition will affect any existing collection of information. However, are there any additional costs or burdens involved in evaluating whether identified deficiencies meet the definition of significant deficiency? If so, what are the types of costs, and the anticipated amounts? In what way can the definition be further modified to mitigate such costs while still appropriately describing deficiencies that should be disclosed to audit committees and auditors?

- We believe one of the benefits of the definition is that it focuses on the desired result of identifying matters that are important enough to merit attention, which will allow management to use sufficient and appropriate judgment to determine the deficiencies that should be reported to the auditor and the audit committee while allowing management to use its judgment to determine what those matters are. Are there additional potential benefits we have not considered? Additionally, a potential consequence of the definition is that, due to the flexibility provided in the definition, there may be less comparability among companies in terms of what management determines is a significant deficiency. Is this accurate? Are there other potential costs or burdens? How should we mitigate such costs or burdens?
- Is there any special impact of the definition of significant deficiency on smaller public companies? If so, what is that impact and how should we address it?

By the Commission.

Dated: June 20, 2007.

Nancy M. Morris,
Secretary.

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¹⁴ See PCAOB Proposed Auditing Standard, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Related Other Proposals* (Release Number 2006-007, Dec. 19, 2006).

¹⁵ This definition of "significant deficiency" is also used in Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with An Audit of Financial Statements*, which was approved by the PCAOB on May 24, 2007.