

COMPLIANCE WEEK

Remediation Center: Remediation Materiality Thresholds

By Parveen Gupta, *Lehigh University* and Tim Leech — January 10, 2006

At the request of subscribers, Compliance Week has launched a Remediation Center, in which readers can submit questions—anonously—to securities and accounting experts. Compliance Week's editors will review all questions and then submit them—confidentially, of course—to specialists who can address the issues. The questions and responses will then be reprinted in a future edition of Compliance Week. Below is one of the Q&As; [ask your own questions by clicking here](#).

THE QUESTION

Anonymous — A December 13 article referenced that significant deficiency remediation status needs to be reported to the SEC in accordance with Section 302 of SOX; however, that assumes a "significant deficiency" meets your disclosure materiality threshold. Am I mistaken, or is there language in Section 302 that requires a significant deficiency to be reported to the SEC?

FIRST ANSWER

Tim Leech, Paisley Consulting — Yes, there is language in the Act that would appear to indicate that this is required.

Section 302(a)(6) states "the signing officers have indicated in the report whether or not there were significant changes in internal controls or other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses".

It isn't clear whether this requirement only applies to events that happen after the evaluation date, or apply to all remediation steps that occur related to any significant deficiencies or material weaknesses that have been identified. It wouldn't appear to make sense to publicly disclose remediation efforts on significant deficiencies if the public has never been told what they are, regardless of whether the event occurred after the evaluation date.

Because of the confusion it is critical that you check with your legal advisors on this issue. Legal advice is particularly appropriate because the guidance issued by the SEC related to Section 404 does not require that you disclose the existence of significant deficiencies. Only material weaknesses must be disclosed under section 404.

The Financial Executive Research Foundation study I conducted with Professor Parveen Gupta on control deficiency filing trends for FERF in 2004 revealed that many companies are, in fact, reporting remediation efforts on significant deficiencies, perhaps in accordance with the section quoted above.

ABOUT THE EXPERTS



Leech

Tim Leech is the principal consultant and chief methodology officer at Paisley Consulting. He was most recently the CEO and founder of CARD@decisions, which was acquired by Paisley Consulting in July 2004.

A former control & risk management services director at Coopers & Lybrand Consulting Group in Toronto, Leech has held a variety of audit and comptroller positions at Gulf Canada Resources (now Conoco) including manager special audit services, and was also managing director of Hambros (UK) Bank subsidiary Network Security Management in Canada. He has also developed software and training for Mobil, Shell, Georgia-Pacific, MBNA, CIBC, Manulife, and many others.

Leech is co-author of a new book from Risk Books titled "Sarbanes-Oxley: A Practical Guide to Implementation Challenges and Global Response," and the 2004 FEI Research Foundation study on SOX control deficiency reporting. Leech is a regular contributor to London-based "Global Risk Regulator," has written numerous guest columns for Compliance Week, and has published technical articles on risk and assurance in professional journals around the world.

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One school of thought holds that when confused by a law and/or regulation, disclose on the side of caution. There are no penalties I am aware of for over disclosing control issues or remediation efforts (again: check with your legal advisors since they may not subscribe to this school of thought).

From a very pragmatic perspective, since no one actually audits for compliance with Section 302, the chances of negative consequences because of noncompliance with Section 302 in the absence of a major corporate governance problem emerging appears remote. We know for example that only a small percentage of companies have identified which employees in the company meet the definition of playing a "significant role" in their controls.

Without knowing who these people are it is difficult to see how their can be high assurance that any fraud they are suspected of committing, "regardless of materiality" will be reported to the Audit Committee and External Auditor as required by section 302(a)(5)(B). External Auditors are not required to report known violations of section 302 as far as I know (again: check with your legal advisors)

SECOND ANSWER

Lehigh Univ. Professor Parveen Gupta — I totally agree with Tim's interpretation [above].

There is nowhere in the [Sarbanes-Oxley] Act or the SEC Final Rules anything that says that to disclose a remediation action pertaining to a significant deficiency, it must meet some disclosure materiality threshold.

Morover, as per the definitions of "more than inconsequential" and "more than remote" the threshold for disclosing the significant deficiencies (if it were the rule) would be extremely low. Thus it would be very difficult to justify non-disclosure of any significant deficiencies and consequently the related remediation actions.

Note: Compliance Week's Remediation Center is an information service only. Answers to questions should not be construed to be legal guidance. Consult with your auditors, internal counsel, and external counsel on all critical compliance and governance matters.

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Parveen P. Gupta is the Frank L. Magee Professor of Accounting at Lehigh University. Considered an innovative professor in the fields of


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An advisor to a number of leading global enterprises, Gupta has recently consulted with Fortune 500 companies such as General Electric, Allied Signal (now Honeywell), Scudder Kemper Investments, and others.

A member of the Professionalism and Ethics Committee of the American Accounting Association, Gupta's research focus includes auditor performance evaluation practices, and international accounting.

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