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How to Use the Changing Components of the Corporate Annual Report

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Examples show how to use new, SOA-required reports.

The amount of information required in a corporate annual report continues to increase. Most recently, additional reporting requirements brought about by the Sarbanes-Oxley Act of 2002 (SOA), the Public Company Accounting Oversight Board (PCAOB) and the Securities and Exchange Commission (SEC) increase the number of component reports that must be included in the annual report package. Lenders need to be familiar with the additional information that these new components provide. Therefore, this article summarizes the required component reports, discusses the information conveyed in each report and gives some examples of the types of significant new information that can be obtained.

Effects of Recent Regulation on Reporting Requirements

Until recently, the required components of the annual report were fairly basic. Each company was required to include audited financial statements and accompanying notes, as well as the report of the independent auditor on the financial statements.[1] Some companies voluntarily added additional reports to the annual report. For example, many companies voluntarily published a "Statement of Management's Responsibility" or similarly named report that set forth management's recognition of its responsibility for the financial statements or financial reporting. Likewise, some companies elected to publish the audit committee report in the annual report.

The most significant and perhaps most controversial provisions of the SOA contain the sections that require annual reports to include the following:

- An internal control report in which management:
  - states its responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
  - assesses the effectiveness of the internal control structure as of the end of the most recent fiscal year
- An assessment of internal control by the auditor to attest to, and report on, the assessment made by management

The controversy surrounding the SOA provisions stems primarily from the perceived costs of compliance. The presence of effective internal controls that safeguard assets and ensure the reliability of financial reporting is something that shareholders, lenders and other users of financial information have assumed was in place all along. Many companies, however, particularly smaller companies, have argued that the costs of compliance with SOA are burdensome and will negatively affect their ability to operate profitably, leading them to argue for an exemption from SOA compliance. While the SEC has not granted an exemption to small companies, it has

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granted two extensions of the compliance date for small companies. The most recent extension allows small companies (market capitalization below $75 million) to postpone compliance until the first fiscal year ending on or after July 15, 2007. Therefore, the reports discussed in this article are currently required only for large public companies but will be required for all public companies within the next few years.

The Required Component Reports

Users of financial statements have noted an increase in the number of component reports included in the annual report and some changes to the existing reports. Exhibit 1 summarizes these components.

Report of Independent Auditor on Audited Financial Statements

The auditor's report on the audited financial statements continues to be an integral part of the financial reporting package. It gives users assurance from an independent professional about whether the financial statements are free of material misstatement and prepared in accordance with generally accepted accounting principles (GAAP).

The changes in the auditor's report on the financial statements after SOA mainly involve only terminology and format issues. First, because public accounting firms are now required to register with the PCAOB before they may conduct audits of public companies, the title of the auditor's report is now "Report of Independent Registered Public Accounting Firm" rather than "Report of Independent Auditor." Also, in the past, the standard auditor's report declared that the audits were conducted "in accordance with generally accepted auditing standards" (GAAS); the new standards require this wording to reflect the authority of the PCAOB, the new auditing standard-setting body.

In addition, the auditor can choose whether to combine the report on the financial statements and the report on internal controls into a single report or to issue two separate reports. If two separate reports are issued, the final paragraph of the report on the financial statements includes a final explanatory paragraph that references the report on internal controls and describes the opinions given in that report.

Management Assessment of Internal Controls

Management is now required to issue a report in which it assesses the effectiveness of the company's internal control over financial reporting. This report includes the following:

- A statement that management is responsible for establishing and maintaining adequate internal control over financial reporting
- A statement identifying the internal control framework used by management to make this assessment
- An assessment of the effectiveness of internal control over financial reporting as of the end of the company's most recent fiscal year, including an explicit statement of whether internal control was effective
- A statement that the registered public accounting firm that audited the financial statements

Exhibit 1 Summary of Component Reports Included in the Corporate Annual Report

Report	Responsible Party	Required Pre-SOA	Required Post-SOA	Source of Reporting Requirement
Report of Independent Auditor on Audited Financial Statements	Auditor	Yes	*Yes	Regulation S-X, Rule 2-02
Management Assessment of Internal Controls	Management	No	Yes	SOA 404(a) and SEC Rel. 33-8238
Attestation on Internal Controls	Auditor	No	*Yes	SOA 404(b) and PCAOB AS-2

* May be issued as two separate reports or one combined report.

has also issued an attestation report on internal control over financial reporting

Many companies in the past voluntarily published a "Statement of Management's Responsibility" or similarly named report. The new required assessment of internal controls report replaces and significantly expands this prior report.

Independent Auditor's Attestation on Internal Controls

The standard auditor's report on internal controls is a lengthy report that contains a definition of internal control, discusses the inherent limitations of internal control and conveys two separate and distinct opinions:

- An opinion on management's assessment of internal control over financial reporting
- The auditor's own opinion on the effectiveness of the company's internal controls

In forming the two opinions on internal control, the auditor must determine whether there are any deficiencies in internal control and, if so, how serious these deficiencies are. Deficiencies can range from insignificant to significant deficiency to material weakness.[2] Only a material weakness is deemed serious enough to warrant an adverse opinion and will be accompanied by a separate paragraph in the report discussing the specifics of the material weakness. Lesser deficiencies do not require the auditor to depart from an unqualified opinion and do not even need to be disclosed in the auditor's report. If a material weakness is discovered and corrected before the end of the fiscal year, the auditor may still issue an unqualified report. Hence, it is important for the user of the financial statements to understand that an unqualified opinion does not mean that internal controls are functioning perfectly or even that they functioned adequately during the year. Rather, an unqualified opinion only means that as of the end of the fiscal year, there were no deficiencies so serious that they met the definition of "material weakness."

Because the auditor issues two distinct opinions on internal control, it is possible for these two opinions to differ. For example, if management has assessed that internal control over financial reporting was not effective, and the auditor agrees with that assessment, the auditor will issue an unqualified opinion on management's assessment and an adverse opinion on internal controls. Also, an adverse opinion on internal controls does not necessarily need to be accompanied by an adverse opinion on the financial statements. An adverse opinion on internal controls means that a material weakness in controls exists, meaning there is more than a remote likelihood that a material misstatement in the financial statements would be neither prevented nor detected by internal controls. However, if the audit of the financial statements shows that no such misstatement *actually occurred* in the financial statements under audit, then it would be appropriate to give an unqualified opinion on the financial statements.

Examples of Use of Component Reports

For some companies, the newly required components do not reveal much additional information that is valuable to lenders (other than the fact that the internal controls are effective). However, for other companies, significant additional information can be obtained. We present first an example where changes have been made but not much additional information is useful to the lender. We then present two examples where some significant issues are raised.

Target Corporation: 2001 vs. 2004

Target Corporation voluntarily included additional component reports in its annual report pre-SOA. Three component reports were included in Target's annual report for the year ended February 3, 2002 (fiscal 2001). In addition to the required "Report of Independent Auditors," Target also included a "Report of Management," in which management acknowledged responsibility for the information in the annual report and discussed the roles of internal control, board of directors oversight and the external audit in helping management to fulfill this responsibility. In addition, Target included a "Report of Audit Committee," in which the audit committee's activities for the year were reported.

Post-SOA, the number of component reports in Target's annual report has grown to five. In the annual report for the year ended January 29, 2005 (fiscal 2004), the voluntary "Report of Audit Committee" remains virtually unchanged. The voluntary "Report of

Management" has been renamed the "Report of Management on the Financial Statements" to distinguish it from the new required "Report of Management on Internal Control" that satisfies the SOA requirements. The "Report of Independent Auditors" has been renamed the "Report of Independent Registered Public Accounting Firm on Consolidated Financial Statements" and includes an additional explanatory paragraph referencing the report on internal controls. Finally, a separate "Report of Independent Registered Public Accounting Firm on Internal Control over Financial Reporting" satisfies the SOA requirement. All three opinions issued by the auditor (opinion on financial statements, opinion on management's assessment and opinion on internal controls) are unqualified opinions.

Revlon, Inc.: Material Weakness in Internal Controls

In "Management's Annual Report on Internal Control over Financial Reporting" for the year ended December 31, 2004, Revlon, Inc.'s management assessed internal controls as being ineffective because of a material weakness in the estimation of reserves for sales returns. Revlon's auditors, KPMG LLP, issued an unqualified opinion on management's assessment of internal controls, indicating agreement with management's conclusion, and an adverse opinion on the effectiveness of internal controls, indicating that it also concluded, based on its own testing, that Revlon's internal controls over financial reporting were ineffective. In a separate report, KPMG rendered an unqualified opinion on Revlon's December 31, 2004, financial statements, since the auditor performed sufficient audit testing to determine that no balances had actually been materially misstated as a result of the identified internal control weakness.

Eastman Kodak Company: A Combined Report Noting a Material Weakness

The component reports included in Eastman Kodak Company's December 31, 2004, annual report are interesting for a few reasons. First, unlike the other examples presented, Kodak's auditor, PricewaterhouseCoopers LLP, chose to present a combined "Report of Independent Registered Public Accounting Firm" that includes opinions on the financial statements, on management's assessment of internal controls and on the effectiveness of internal controls in a single report. This report gives an unqualified opinion on the financial statements, an unqualified opinion on management's assessment that internal controls were ineffective and an adverse opinion on the effectiveness of internal controls. The material weaknesses in this case pertain to the accounting for income taxes, pensions and other postretirement benefits. Again, the auditor was able to perform sufficient audit testing of the financial statement balances to determine that no balances were materially misstated despite the identified control weaknesses. Another interesting item to note in this case is the fact that the company has restated its 2003 financial statements primarily for certain income tax and pension and postretirement benefit matters. Apparently, the discovery of internal control weaknesses during 2004 uncovered errors in past years' account balances that presumably would not have been discovered without the SOA-required internal control testing.

Additional Information Sources

In response to numerous high-profile corporate scandals (Enron, WorldCom), the SOA and the PCAOB, in conjunction with new rules issued by the SEC, have created additional reporting requirements for public companies. This has resulted in an increase in the number of component reports that must be included in the annual report. In some cases, lenders can obtain significant new information in the newly required components of the annual report package.

Endnotes

1 The annual report package is also required to include a five-year summary of selected financial data, market data on common stock prices and Management's Discussion and Analysis of Financial Condition and Results of Operations. Since recent regulation has not significantly affected these items, the analysis in this study does not focus on those items.

2 An *insignificant deficiency* is one in which the magnitude of any resulting misstatement to the financial statements is inconsequential. A *significant deficiency* is one in which there is a more than remote likelihood that the deficiency could lead to a consequential misstatement of the financial statements. A material weakness is a deficiency that is serious enough that there is a more than remote likelihood that the deficiency could lead to a material misstatement of the financial statements. These terms are defined in PCAOB Auditing Standard No. 2, ¶¶8–10.