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## Demystifying Disclosure Controls

Understanding them to effectively leverage towards objectives

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It's been more than ten years since the SEC issued their final rule on disclosure controls ([SEC Release No. 33-8238](#)) and confusion still reigns. Confusion can lead to missed opportunities for mitigating disclosure risks and leveraging disclosure controls across the entity in reaching multiple objectives. This article explores disclosure controls, from both the standpoint of the SEC's definition for publicly traded companies and for all types of organizations beyond the SEC's definition, in an effort to demystify this important topic.

### Disclosure Controls Defined

Disclosure requirements are defined by stakeholder groups such as creditors, governments and regulators. All organizations are subject to some degree of disclosure requirements, which are also commonly called external reporting requirements. They can be as simple as applying for a business license or filing tax returns. In general terms, disclosure controls are policies and procedures to help ensure that external disclosures are prepared and delivered in accordance with the applicable external reporting requirements. Typical assertions associated with disclosure controls include accuracy, timeliness and completeness.

Publicly traded companies subject to filing periodic reports (10-Qs and 10-Ks) with the SEC must include a certification<sup>1</sup> by the CEO and CFO, or persons performing similar functions, in each periodic report to disclose their conclusions regarding the effectiveness of disclosure controls and procedures. The SEC defines disclosure controls and procedures as:

*Controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the Act (15 U.S.C. 78a et seq.) is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Act is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.<sup>2</sup>*

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<sup>1</sup> Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

<sup>2</sup> Per SEC Reg13A.T.Rule13a-15(e) and SEC Reg15D.T.Rule15d-15(e).



In addition, the periodic certification by the CEO and CFO must include the following statements relevant to disclosure controls and procedures as defined by the SEC:<sup>3</sup>

- ⑥ *Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;*
- ⑥ *The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures for the registrant and have:*
  - *Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared.*
  - *Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation.*

Collectively, the SEC's definition of disclosure controls and procedures, as well as the periodic certification requirements discussed above, requires periodic reports to be materially correct and all disclosures filed or submitted under the Securities Exchange Act of 1934 to be properly disclosed in a timely manner. This includes all forms and submittals required by the Act of 1934, such as: Form 8-K current reports, Form 10-Q and Form 10-K periodic reports, Form SD specialized disclosure reports for conflict minerals, and Schedule 14A proxy statements.

### **Clearing the Air on Common Misunderstandings**

1. *Disclosure controls only pertain to the financial statements and internal control over financial reporting (ICFR):* This is not true. However, it is easy to see the confusion for a couple of reasons. First, the term “disclosures” is also commonly used to refer to the footnotes of financial statements. Second, the SEC disclosure control requirements were born from the Sarbanes-Oxley Act of 2002 (SOX), which people commonly associate solely with ICFR rather than the wide range of topics it covers. Third, the periodic certification requirements also have clauses specific to ICFR. The SEC has a separate definition for ICFR,<sup>4</sup> and while there is substantial overlap between disclosure controls and ICFR since the financial statements are also a disclosure, the definitions are very different. Disclosure controls have a much broader reach since the definition essentially covers all disclosures in SEC filings required by the Securities Exchange Act of 1934.
2. *Disclosure controls is a compliance topic that does not deserve much attention:* Wrong. While the term ‘compliance’ has turned into somewhat of a negative term in some business circles, its importance should be obvious. A great deal of attention to ICFR was triggered by SOX, however, the vast majority of companies had decent accounting and financial reporting controls long before

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<sup>3</sup> Per SEC RegS-K.T.Item601

<sup>4</sup> Per SEC Reg13A.T.Rule13a-15(f) and SEC Reg15D.T.Rule15d-15(f).



the legislation was signed into law in 2002. The same is true with disclosure controls in that it simply makes sound business sense. Robust policies and procedures to help ensure that material disclosures are accurate, timely and complete helps to protect the organization and should be operating effectively whether they are required by legal requirements or not. The interests of stakeholder groups such as governments, creditors and regulators are essential to the success of any business and ignoring or under-resourcing their requirements is a recipe for disaster that can lead to adverse legal actions. A company's reputation is at stake whenever they report to external parties.

3. *Investing in disclosure controls is not a priority since external audit requirements do not apply:* While it is correct that no external audit requirements exist for SEC disclosures outside the financial statements and SEC Regulation S-X requirements, adequate resources towards disclosure controls is prudent for the reasons previously stated. Further, external audit requirements for non-financial disclosures can apply to some organizations, especially for federally-funded nonprofits.
4. *SEC disclosures do not relate to risk management assertions:* Obviously, it depends on the particular disclosure; however, it often does come into play for proxy statements. Final [SEC rule #33-9089](#) expanded corporate proxy disclosures regarding risk management, compensation and corporate governance matters (refer to previous article on [proxy enhancements](#) for more details). For example, Yahoo's proxy statement filed with the SEC on April 30, 2014, includes the following disclosure: *"With respect to the Company's compensation arrangements, the Company has reviewed its compensation policies and practices and concluded that such policies and practices do not create risks that are reasonably likely to have a material adverse effect on the Company."* This is an assertion through the Company's conclusion, and while it is specific to compensation, this is part of risk management.
5. *Disclosure controls are not disclosed in SEC filings:* While the vast majority of disclosure controls are likely not disclosed in SEC filings, some are. Using the Yahoo example cited above, the next sentence of their proxy statement reads: *"In particular, the Compensation Committee, with input from its independent compensation consultant, FW Cook, assessed the compensation arrangements for the Company's executive officers and reviewed incentive and commission arrangements below the executive level, and concluded that they do not encourage unnecessary or excessive risk-taking."* In this example, the Company is conveying one of their disclosure controls in stating that they utilized an independent compensation consultant to help conclude on the assertion identified previously. Another common example is the disclosure of a Disclosure Committee, such as:

*"We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed by us in the reports we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer (principal executive officer) and Chief Financial Officer (principal financial officer), as appropriate to allow timely decisions regarding required disclosure. We have established a Disclosure Committee, consisting of certain members of management, to assist in this evaluation. Our Disclosure Committee meets on a quarterly basis and more often if necessary."<sup>5</sup>*

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<sup>5</sup> Item 9A of Form 10-K for hhgregg, Inc., filed with the SEC on May 20, 2014



## Leveraging Disclosure Controls

Companies need to challenge their disclosure controls to ensure adequacy in meeting external disclosure and reporting requirements. They should also explore opportunities for leveraging them as oftentimes these can be powerful controls for multiple purposes. One opportunity is to expand them to include coverage of internal reporting objectives such as the accuracy, timeliness and completeness of data and information feeding into the decision-making process. This is a significant risk to many companies as decisions are oftentimes made on faulty data, assumptions and conclusions thanks to a lack of controls. Of course, a term such as ‘internal reporting controls’ or ‘internal disclosure controls’ will be more appropriate to differentiate from external disclosure controls.

Another opportunity, especially for public companies, is to utilize disclosure controls for addressing the 17 principles per COSO’s *Internal Control – Integrated Framework* 2013 (Framework). There should be plenty of opportunities to map existing disclosure controls including: legal reviews, Disclosure Committee activities, internal representations and board reviews for certain principles within all five components of the Framework. For example, these noted disclosures controls can and should be leveraged for principle seven regarding identifying and analyzing risks relevant to the achievement of objectives (for SOX-404 purposes, these would be external financial reporting objectives). Indeed, the points of focus examples provided by the Framework for principle seven lineups nicely to these disclosure control examples. Other Framework principles that align well to common disclosure controls include numbers 2, 9, 10, 11, 12, 13, 14, 15, 16 and 17 (refer to COSO’s [Executive Summary](#) for identification of these principles).

Remember that disclosing accurate, timely and complete information to the SEC and other stakeholders is not an option, but rather an obligation to protect your shareholders. A misstep can be costly both in terms of a company’s reputation and adverse regulatory and legal actions.

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