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## SEC Administrative Case Reinforces Current Emphasis on Internal Controls

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Consistent with its current focus on internal control over financial reporting (ICFR), the Securities and Exchange Commission recently sanctioned a company and individuals for failing to adequately evaluate and audit the company's ICFR. In [settled orders](#), the Commission alleged that Magnum Hunter Resources Corporation (MHR) violated the SEC's periodic reporting rules when it reported management's conclusions that MHR's ICFR was effective as of December 31, 2011.

In the orders, the SEC alleged that a consultant to MHR had identified as a control deficiency "inadequate and inappropriately aligned [accounting] staffing," which resulted in delays in preparing financial statements and reports, and which presented "substantial risk" of misstatement. The consultant concluded that the staffing deficiency represented only a significant deficiency and did not rise to the level of a material weakness in ICFR. According to the SEC, the consultant did not explain how a "substantial risk" of financial statement error did not constitute "material weakness," which is defined as a deficiency in ICFR that creates a "reasonable possibility of a material misstatement [of financial statements] not being prevented or detected on a timely basis." The SEC alleged that MHR management failed to properly evaluate ICFR, particularly in accepting the consultant's findings and relying on the absence of an actual material error in MHR's financial statements as evidence that a material weakness did not exist. The SEC emphasized that a material weakness only requires a reasonable possibility of an error, not an actual misstatement. The SEC also stated that MHR failed to create adequate documentation to support its management's assessment of ICFR.

The SEC also settled charges against MHR's chief financial officer and chief accounting officer, and the consultant, who it found caused the CFO's and CAO's violations. The SEC also sanctioned the engagement partner on MHR's ICFR audit, alleging that the partner incorrectly applied Auditing Standard No. 5 in finding that MHR's ICFR was effective and did not maintain adequate documentation as required by the auditing standards.

The *Magnum Hunter* case is the latest in a series of enforcement cases involving ICFR. It is noteworthy because it involves a "pure" ICFR violation, as opposed to cases where ICFR violations are alleged in connection with other accounting violations. The case also emphasizes the point that

the existence of a material weakness as of a particular date does not turn on whether a material misstatement actually occurs (although in this case the control deficiencies do appear to have eventually contributed to a restatement).

*Magnum Hunter* is also consistent with the SEC's emphasis on the importance of ICFR generally. For example, in a [December 2015 speech](#), Chair Mary Jo White expressed her view that "it is hard to think of an area more important than ICFR to our shared mission of providing high-quality financial information that investors can rely on." The SEC has also attempted to address complaints, notably from the US Chamber of Commerce, that the Public Company Accounting Oversight Board's emphasis on ICFR audits in its inspection process has increased costs and burdens of ICFR compliance. In a [March 22 speech](#), Chief Accountant James Schnurr noted, as other staff members have regularly, that PCAOB inspections continue to identify deficiencies in ICFR audits and that some audit deficiencies "may be, at least in part, indicative of deficiencies in management's design or operation of controls...." Mr. Schnurr reported that the PCAOB, with him and his staff observing, "has conducted a number of outreach meetings with preparers, auditors and other constituents to better understand the concerns and challenges in this area." He encouraged "regular discussions between management, auditors, and audit committees on existing and emerging issues in assessments of ICFR."

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