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Business development companies

Considerations related to internal controls over financial reporting (ICFR)

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Financial Services

Business development companies (BDCs) are registered with the Securities and Exchange Commission (SEC) under the Securities Exchange Act of 1934 (the 1934 Act). BDCs offer equity interests to investors, either through a listing on a securities exchange (listed BDCs) or bypassing a securities exchange to sell their equity interests directly to investors (non-listed BDCs). Both listed and non-listed BDCs are registered with the SEC and considered to be public issuers as defined by the SEC and the Sarbanes-Oxley Act of 2002 (SOX). As a result, a BDC must engage an independent public accounting firm (independent auditor) that is registered with the Public Company Accounting Oversight Board (PCAOB) to perform an audit and issue an audit report on the BDC's annual financial statements and to perform certain review procedures related to the BDC's quarterly financial statements (for which no separate report is required). Such registered independent auditor must perform procedures and comply with the standards issued by the PCAOB. The 1934 Act requires domestic issuers, including BDCs, to file an annual report on Form 10-K and quarterly reports on Form 10-Q with the SEC.

As public issuers, all BDCs are also required to comply with the applicable rules established by SOX regarding management certification with respect to financial statement presentation (Section 906) and certification and assessment of the design and effectiveness of internal controls over financial reporting (ICFR) (Sections 302 and 404(a)). Additionally, many BDCs are required to comply with Section 404(b) of SOX.

Compliance with Section 404(a) requires that public issuers evaluate the design and operating effectiveness of their ICFR and include a report on their assessment of the effectiveness (also referred to as management's assessment on ICFR). Some of these public issuers (discussed in detail on the following page) are also required to engage their public accounting firm that is registered with the PCAOB to independently test their ICFR and issue an

attestation report on their effectiveness (independent auditor's report on ICFR) to comply with Section 404(b), in addition to the audit of the financial statements. Compliance with Section 404(b) can add incremental costs to the operations of the BDC. These consist of costs for management to document and evaluate its ICFR, as well as the costs to engage the independent auditor to perform an audit of internal control over financial reporting in conjunction with the audit of the financial statements (integrated audit).

The 1934 Act establishes different classes of filers — non-accelerated filer, accelerated filer and large accelerated filer. The deadlines for filing of a company's Form 10-K and Form 10-Q are determined by its filing status. In addition to determining its filing deadlines, a company's filing status also determines whether the company is required to comply with Section 404(b).

Non-accelerated filer

The term "non-accelerated filer" is not defined in Rule 12b-2 or elsewhere in the SEC's rules. However, the SEC staff has indicated that the term is used to "refer to an Exchange Act reporting company that does not meet the Rule 12b-2 definition of either an 'accelerated filer' or a 'large accelerated filer.'"

Accelerated filer

Currently, Rule 12b-2 of the Exchange Act defines an "accelerated filer" as a seasoned issuer with a public float of outstanding equity ownership of $75 million or more, but less than $700 million. As a result of recent rulemaking activities, these financial thresholds may change in the future. Specifically, Rule 12b-2 defines an accelerated filer as a public company that meets all of the following conditions as of the end of its fiscal year:

- Has a public float, as defined, of $75 million or more but less than $700 million (measured as of the last business day of its most recent second fiscal quarter)
- Has been a public company for at least 12 months subject to the reporting requirements of Section 13(a) or 15(d) of the 1934 Act
- Has previously filed at least one annual report
- Is not eligible to report as a smaller reporting company[1]

[1]Since an investment company is not eligible to report as a smaller reporting company, this condition is not applicable to a BDC.

Large accelerated filer

Rule 12b-2 of the Exchange Act defines a "large accelerated filer" as a seasoned issuer with a public float of $700 million or more. Specifically, Rule 12b-2 defines a large accelerated filer as a public company that meets all of the following conditions as of the end of its fiscal year:

- Has a public float, as defined, of $700 million or more (measured as of the last business day of its most recent second fiscal quarter)
- Has been a public company for at least 12 months[2] and subject to the reporting requirements of Section 13(a) or 15(d) of the 1934 Act
- Has previously filed at least one annual report
- Is not eligible to report as a smaller reporting company[3]

All large accelerated and accelerated filers (excluding emerging growth companies) are required to comply with Section 404(b) to include an independent auditor's report on ICFR. Non-accelerated filers and emerging growth companies are exempted from the requirements of Section 404(b).

A summary of the filing deadline is as follows:

	Deadlines for filing after fiscal year-end or fiscal quarter-end		
	Large accelerated	Accelerated	Non-accelerated
Annual reports (10-K)	60 days	75 days	90 days
Interim reports (10-Q)	40 days	40 days	45 days

The Jumpstart Our Business Startups Act of 2012 (JOBS Act)

JOBS Act introduced emerging growth companies (EGCs) as an additional filing status for newly formed companies that meet certain criteria. An EGC is provided relief from certain regulations, including compliance with Section 404(b), and can retain that status for up to five years after its common equity initial public offering (IPO). An EGC could lose its EGC status earlier if it meets any of the following criteria:

- Has annual revenue exceeding $1.07 billion during its most recently completed fiscal year
- Issues more than $1 billion in non-convertible debt securities over a rolling 36-month period, including securities issued in registered or unregistered offerings
- Becomes a large accelerated filer

Under the JOBS Act, a BDC that meets the definition of an EGC is provided relief from obtaining and including an independent auditor's report on ICFR in its Form 10-K. Despite the potential five-year "grace period," BDCs that qualify as EGCs should remain cognizant of internal control requirements applicable to them under Section 404(a). EGC status does not remove or delay the requirement in Section 404(a) of SOX beyond the first annual report. Therefore, it is critical that management considers ICFR and plans ahead to document and test its systems in anticipation of management's assessment and the eventual integrated audit requirements.

Further, management should remain alert for changes in a BDC's filing status that could require its compliance with Section 404(b). Such changes would most likely occur if the BDC grows in size or otherwise at the end of the five-year deferral allowed under the JOBS Act. Additionally, a non-listed BDC that engages in a listing transaction or merges with another listed BDC may have to comply with Section 404(b) if it does not qualify as an EGC.

[2]A calendar month for purposes of applying this requirement comprises an entire month. For example, if a registrant became subject to the requirements of Section 13(a) of the Exchange Act on 15 January and remained subject to it through the end of the year, it would have been subject to Section 13(a) for 11 months as of 31 December.

[3]See note 1.

Definition and scope of ICFR

Rules 13a-15(a) and 15d-15(a) require registrants to maintain "internal control over financial reporting." Exchange Act Rules 13a-15(f) and 15d-15(f) define the term "internal control over financial reporting" as:

"A process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and
- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements."

This definition is consistent with the definition of internal accounting controls in Section 13 of the Exchange Act, which was added by the Foreign Corrupt Practices Act of 1977. The SEC doesn't have specific rules informing public companies how to design and implement an effective system of internal control. There is, however, useful guidance available from other sources. One of these is the internal control framework set out by a private-sector organization called the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

COSO overview

COSO is a voluntary private-sector organization dedicated to improving the quality of financial reporting through business ethics, effective internal control and corporate governance. In 1992, COSO released its Internal Control – Integrated Framework (the original framework). The original framework has gained broad acceptance and is widely used. It is recognized as the leading framework for designing, implementing and conducting internal control and assessing the effectiveness of ICFR. COSO released an updated framework in 2013 to reflect changes in the business and operating environment, including the increased use of technology, that have occurred since the original framework was issued. The updated framework defines internal control as "a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives relating to operations, reporting and compliance." It describes three categories of objectives of internal control – operations, reporting and compliance. Underlying these objectives are five integrated components of internal control:

1. Control environment
2. Risk assessment
3. Control activities
4. Information and communication
5. Monitoring activities

The updated framework also sets out 17 principles associated with the five components, which are intended to provide clarity regarding the requirements for effective internal control. Because the 17 principles are drawn directly from the components, they are presumed to be present and functioning for a system of internal control to be effective.

The five components and relevant principles, as they relate to the objective of external financial reporting, form the basis for management's evaluation, and that of the independent auditor, of their system for ICFR.

Scope of management's assessment

Because the process of evaluating ICFR will vary from company to company, SEC rules do not specify the methods or procedures to be performed in an evaluation.

In adopting its Section 404 reporting rules in 2003, the SEC stated:

"The assessment of a company's internal control over financial reporting must be based on procedures sufficient both to evaluate its design and to test its operating effectiveness. Controls subject to such assessment include, but are not limited to:

- Controls over initiating, recording, processing and reconciling account balances, classes of transactions and disclosure and related assertions included in the financial statements;
- Controls related to the initiation and processing of non-routine and non-systematic transactions;
- Controls related to the selection and application of appropriate accounting policies;
- Controls related to the prevention, identification and detection of fraud."

In addition to controls stated above, following controls are also important in management's assessment:

- Controls over significant, unusual transactions, particularly those that result in late or unusual journal entries;
- Controls related to management override in financial reporting;
- Controls over related party transactions;
- Controls related to significant management estimates.

The nature of a BDC's testing activities will largely depend on the circumstances of the BDC and the significance of the controls being tested. An assessment of the effectiveness of ICFR must be supported by evidential matter, including documentation, regarding both the design of internal control and evidence supporting that controls are operating effectively. This evidential matter should provide reasonable support for how a company's controls are designed to address identified risks; the procedures performed to gather and evaluate evidence about the operating effectiveness of a company's controls; and the basis for the company's determination that controls were operating effectively.

External service providers

The SEC's adopting release also acknowledges that, while management is ultimately responsible for the assessment of ICFR, the necessary controls to detect and prevent material misstatement to the company's financial reporting may be conducted by non-management personnel acting under the supervision of management.

BDCs may employ outside service providers, such as external administrators, valuation specialists or custodians, to perform various functions within their systems of internal control. Some outside service providers undertake a process to have their internal controls tested and reported on by their own independent auditors. Obtaining and reviewing such reports may help management of the BDC in its ICFR assessment.

In addition, BDCs oftentimes engage third parties to help management's assessment and testing of ICFR. These third parties are generally accounting firms (other than the BDC's independent auditor) or other firms that specialize in documenting and testing ICFR. These third parties provide such services under the direction of management and in coordination with the BDC's independent auditors.

Internal control considerations for valuation of investments

While BDCs are required to have effective internal controls over all aspects of financial reporting, the valuation of investments is one of the most significant. Every BDC organization has a different set of processes and controls over the investment valuation process. However, by and large, the processes and controls will focus primarily on the following areas:

- Establishing a methodology for determining fair value
- Obtaining and validating source data and clerical accuracy for use in a valuation model
- Reviewing and approving the results of model outputs with consideration of other market data (if available)

Furthermore, the controls over this process typically involve reviews of the data, methods, models and valuation assumptions and inputs used. The combination of a high degree of judgment and qualitative reviews places significant burdens on organizations to demonstrate the proper functioning of the review controls used in the determination of fair value. In performance of the control, management must demonstrate that its review of the data, methods, model and valuation assumptions and inputs is sufficient to identify potential errors. Management must also demonstrate how it has addressed and resolved errors identified in the course of performing its control procedures.

Audit committee oversight

Another important element in an effective system of ICFR is the audit committee's oversight over the issuer's external financial reporting and ICFR. While management has the primary responsibility for preparing a BDC's financial statements and disclosures, the audit committee's responsibilities include the oversight of management's ICFR and management's process for preparing the financial statements. To accomplish this, the audit committee should actively engage management to help committee members understand the BDC's financial statements and disclosures. In addition, such oversight also should include consideration of controls to prevent or detect management override, how management identifies and assesses fraud risks, and management's evaluation of whether a material weakness exists.

Role of the independent auditor and importance of coordination with management

In situations where the independent auditor is required to audit the BDC's ICFR, the BDC's management and any third-party representatives should communicate early and often with the independent auditor. This communication should include management's assessment approach in order to communicate and understand expectations, professional standards and other requirements of each party.

The independent auditor must plan and perform the ICFR integrated audit to obtain appropriate evidence that is sufficient to obtain reasonable assurance about whether material weaknesses exist as of the date specified in management's assessment (fiscal year-end). When performing its assessment of the effectiveness of ICFR, the independent auditor performs the following procedures, among others:

- Interviews management and the key players who were involved in the assessment
- Reviews management's documentation supporting its assessment
- Performs tests of the internal controls at both the entity level and process level to evaluate whether controls are designed and operating at a level of precision necessary to prevent material misstatement
- Evaluates whether the body of evidence supports management's assertions on internal controls
- Evaluates and discusses with management and the audit committee significant findings from the evaluation process, including whether any significant deficiencies or material weaknesses were identified

As part of the audit, the independent auditor evaluates any control deficiencies identified. The severity of a deficiency depends on 1) whether there is a reasonable possibility that the company's controls will fail to prevent or detect a misstatement of an account balance or disclosure and 2) the magnitude of the potential misstatement resulting from the deficiency or deficiencies. To the extent that it is determined that deficiencies exist such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis, management and/or the independent auditors must conclude that a material weakness in ICFR exists and therefore, conclude that ICFR is ineffective. It is important to note that the absence of errors in the financial statements of a company does not necessarily preclude the existence of an internal control deficiency or material weakness in ICFR.

Final thoughts

Management's recognition and awareness of its ongoing responsibilities are the most critical components to designing, implementing and completing successful annual assessments of ICFR. By the nature of its involvement with day-to-day operations, management is most familiar with the specific business and financial reporting risks facing the BDC and should constantly challenge itself to determine whether the BDC's processes and controls, and the documentation of those controls, are directly and adequately responding to the BDC's unique risks.

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