



808 Accounting Developments & Section 404 One Year Later

Michael Gaynor
Professional Accounting Fellow
U.S. Securities and Exchange Commission

Howard F. Kline
General Counsel
Legacy Electronics, Inc.

Mary Sjoquist
Special Counsel
Public Company Accounting Oversight Board

Jonathan D. Yellin
Vice President, General Counsel
CRA International

Faculty Biographies

Michael Gaynor

Professional Accounting Fellow
U.S. Securities and Exchange Commission

Howard F. Kline

Howard F. Kline was formerly general counsel and is currently special counsel to Legacy Electronics, Inc., an electronics and memory manufacturer in San Clemente, California. In this capacity, Mr. Kline works directly with board members and senior staff of the company on a broad range of legal, intellectual property, business, litigation, corporate, and compliance matters.

In addition to his responsibilities at Legacy, Mr. Kline has served as general counsel, vice president, business administration and legal affairs for Security First Corp., a startup biometric and security software firm. He was also a partner at Berger Kahn, Shafton, Moss, Figler, Simon & Gladstone, general counsel at Allied Education Corporation, a large national education company, and general counsel at Big Bear Supermarkets, a large regional supermarket chain and shopping center developer. Mr. Kline has been advising companies on legal and business matters for nearly 30 years.

Mr. Kline is active in ACC's Corporate & Securities Committee. Mr. Kline has been a frequent speaker and has written many articles on general legal and business topics including those on corporate governance, compliance, ethics, management, and real estate.

He has a B.A. from the State University College of New York at Oneonta, New York and a J.D. from the Western State University College of Law.

Mary Sjoquist

Mary M. Sjoquist is currently special counsel to the Public Company Accounting Oversight Board (PCAOB). In this capacity, Ms. Sjoquist works directly with board members and senior staff of the PCAOB in formulating the rules required by the Sarbanes-Oxley Act of 2002, new and revised auditing standards, and other policies affecting registered public accounting firms.

Prior to joining the PCAOB, Ms. Sjoquist was a partner at Patton Boggs LLP, a large national law firm, where she chaired the firm's business practice group. Ms. Sjoquist has been a securities practitioner for more than 20 years and has focused her practice on securities offerings, mergers and acquisitions, representation of public companies reporting to the Securities and Exchange Commission, crisis management, and corporate governance. In addition to her private practice experience, Ms. Sjoquist also spent four years with the SEC's Division of Corporation Finance.

Ms. Sjoquist has been a frequent speaker and has appeared on many panels focusing on Public Company Accounting Oversight Board matters, corporate governance, crisis management, and securities regulation. She is a member of the District of Columbia Bar Association and is active in the ABA's federal regulation of securities committee and the securities subcommittee of the small business committee. Ms. Sjoquist is also a member of the board of the national capital area chapter of the National Association of Corporate Directors.

She has a B.A. from the University of Waterloo, Canada and a J.D. from the Catholic University of America, Columbus School of Law.

Jonathan D. Yellin

Jonathan D. Yellin is vice president and general counsel for CRA International, Inc., headquartered in Boston, with 23 offices worldwide. His responsibilities include oversight of all legal matters, both domestically and internationally, acquisitions, public offerings, contract negotiations, board related matters, and employment issues.

Prior to joining CRA, he was a partner at the Boston based law firm of Riemer & Braunstein LLP where he specialized in restructurings, asset sales and acquisitions, turnarounds, and business law.

He is a member of the Boston chapter of the Association for Corporate Growth and was formally a board member for the New England chapter of the Turnaround Management Association.

Mr. Yellin received his B.A. from George Washington University and is a graduate of the University of Miami School of Law, cum laude.



Sarbanes Oxley: Section 404 – One Year Later

Michael G. Gaynor
Professional Accounting Fellow
Office of Chief Accountant
U.S. Securities and Exchange Commission

The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues upon the staff of the Commission.

ACC's 2005 Annual Meeting: Legal Underdog to Corporate
Superhero—Using Compliance for a Competitive Advantage

October 17-19, Marriott
Wardman Park Hotel



Agenda

- Current Activities Related to 404
 - Monitoring reporting results
 - Evaluating feedback
 - Recently issued guidance

ACC's 2005 Annual Meeting: Legal Underdog to Corporate
Superhero—Using Compliance for a Competitive Advantage

Prepared by Michael Gaynor
U.S. Securities & Exchange Commission



Reporting Results So Far...

- *Through early October:*
 - 3,460 filings
 - 487 (14.1%) received audit opinion indicating ineffective ICFR
 - Over 50% had revenues less than \$500 million
 - Conversely, less than 10% had revenues greater than \$5 billion



Reporting Results So Far...

	Filed reports by industry	With MW (% of 487)
Manufacturing	35%	34%
Finance, Insurance, Real Estate	26%	16%
Services	15%	21%
Transportation, Communication, Utilities	11%	10%
Wholesale and Retail Trade	8%	14%
Other	5%	5%



Adverse Opinions

What types of issues did they have?

- Accounting failures (GAAP) with respect to specific accounts (97%)
- Accounting documentation, policy and procedures (90%)
- Material or numerous auditor/year-end adjustments (56%)
- Accounting personnel resources, training/competency issues (48%)
- Restatement or non-reliance on financial statements (42%)



Roundtable on Implementation of Internal Control Reporting Provisions

- Announcement of Roundtable and request for public comment
 - Over 200 comment letters received
- Roundtable held April 13th
 - 54 participants
 - Representing issuers, auditors, investors, audit committees, and members of the legal community
 - 6 panels focusing on different topics



Roundtable and Comment Letters

What We Heard:

- Benefits of 404 Implementation
 - Promotes investor confidence
 - Leads to widespread understanding throughout organizations of the importance of internal controls
 - Increased knowledge and focus on controls
 - Realized improvements to internal controls
 - Improved controls documentation



Roundtable and Comment Letters

What We Heard:

- Costs
 - Significant training efforts
 - Deferred maintenance
 - Development of controls
 - Documentation of controls
 - Automation of controls
 - Integration of systems
 - Auditor costs – greater than expected
 - Opportunity costs



Roundtable and Comment Letters

What We Heard:

- Common areas of concern:
 - Scope of testing
 - Using the work of management and others
 - Communications with auditors
 - IT general computer controls / new systems



What We've Done: SEC Staff Statement

- May 16, 2005 Commission and Staff Statement issued
 - Reasonable Assurance
 - Top-Down Approach / Risk-Based Assessments
 - Scope of Assessments
 - Timing of Management's Testing
 - Evaluating Control Deficiencies
 - Disclosures About Material Weaknesses
 - Information Technology Issues
 - Communications with Auditors



SEC Staff Statement

● Reasonable Assurance

- Level of assurance regarding the reliability of financial statements and internal controls over financial reporting
- Reasonable assurance does not mean absolute assurance but it does mean a high level of assurance

SEC Staff Statement

● Top-Down / Risk Based Assessments

- Focus should be on controls and accounts most likely to have a material impact on financial statements
- Resources should be devoted to areas of greatest risk
- Assessments should not be “check the box” exercises



SEC Staff Statement

● Scope of Assessments

- Judgment should be used in identifying accounts and controls to test
- Judgment should be used in determining the nature & extent of testing
- Testing should relate to the risk of material misstatements in the annual, not interim financial statements



SEC Staff Statement

● Timing of Management's Testing

- Judgment should be used in identifying accounts and controls to test
 - Effective testing and assessment may be performed during the year
 - Judgment must be used in determining additional testing required closer to year-end
- ### ● Evaluating Control Deficiencies
- Judgment should be used in identifying accounts and controls to test



SEC Staff Statement

● Disclosures About Material Weaknesses

- The nature of the weakness
- The impact of the weakness on financial reporting and the control environment
- Plans for remediating the weakness

SEC Staff Statement

● Information Technology Issues

- Include relevant IT controls in the assessment (controls related to financial reporting)
- Judgment must be used in identifying IT controls to test
- Include IT upgrades and new systems in assessments



SEC Staff Statement

- Communications with Auditors
 - The chilling effect was an unintended consequence
 - Auditor's discussing and exchanging views with management does not in itself violate independence principles or indicate a material weakness
 - Judgment is required in ongoing dialogues with management



Other Recent Activity – Proposed Rules

- Definition of an accelerated filer
 - Create “large accelerated filer” category – public float of \$700m or more
 - Adjust “accelerated filer” category – public float of at least \$75 m but less than \$700m
 - Ease restrictions for exiting accelerated filer status
- Periodic report filing deadlines
 - Large accelerated filer – 60 days for 10-K and 40 days for 10-Q
 - Accelerated filer – 75 days for 10-K and 40 days for 10-Q



Other Recent Activity

- Extension 404 compliance dates
 - Applies to companies that are not an accelerated filer, including foreign private issuers that are not an accelerated filer
 - Required to comply in annual reports for first fiscal year ending on or after July 15, 2007
 - A foreign registrants that is an accelerated filer must comply in annual reports for first fiscal year ending on or after July 15, 2006
- Committee of Sponsoring Organizations (COSO)
- SEC Advisory Committee on Smaller Public Companies



Additional Information

- *Additional information regarding the roundtable, including an archived webcast and comment letters, is available on the SEC's website at:*
 - *<http://www.sec.gov/spotlight/soxcomp.html>*



Sarbanes Oxley: Section 404 In-House Perspective

Jonathan Yellin
General Counsel
CRA International

&

Howard F. Kline
Special Counsel
Legacy Electronics, Inc.

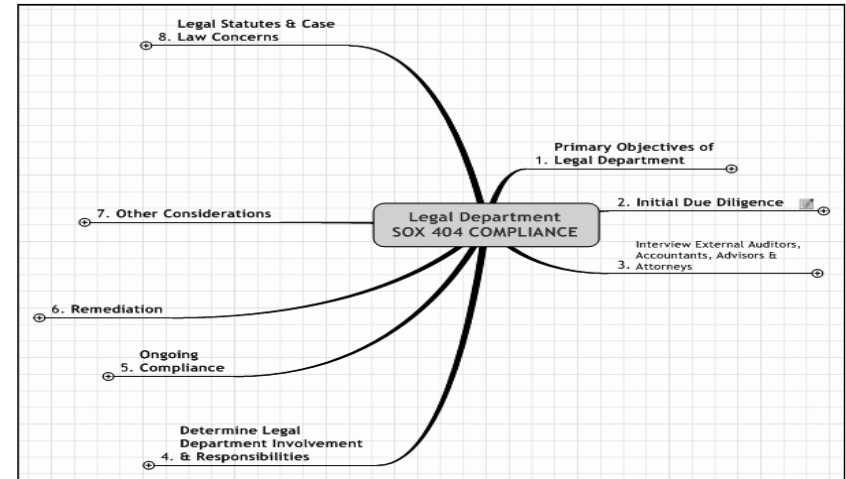
The views expressed herein are individual views of Jonathan Yellin and/or Howard F. Kline, respectively and do not necessarily reflect the views of their employers, clients or their colleagues.

ACC's 2005 Annual Meeting: Legal Underdog to Corporate Superhero—Using Compliance for a Competitive Advantage

October 17-19, Marriott Wardman Park Hotel



General Overview



ACC's 2005 Annual Meeting: Legal Underdog to Corporate Superhero—Using Compliance for a Competitive Advantage

October 17-19, Marriott Wardman Park Hotel



Primary Objectives of Legal Department

1. Coordinate SOX 404 responsibilities with other corporate responsibilities and objectives
2. Advise/Assist the CEO and CFO of his/her Responsibilities
3. Advise/Assist the Board on its responsibilities
4. Insure Corporation fully complies with all laws including the requirements of SOX 404

ACC's 2005 Annual Meeting: Legal Underdog to Corporate Superhero—Using Compliance for a Competitive Advantage

October 17-19, Marriott Wardman Park Hotel



Advise/Assist the Board on its responsibilities

- Advise/Assist Audit Committee on its responsibilities
- Advise and/or participate with Disclosure Committee, if you have one.
 - Determine duplication and promote coordination of compliance efforts

ACC's 2005 Annual Meeting: Legal Underdog to Corporate Superhero—Using Compliance for a Competitive Advantage

October 17-19, Marriott Wardman Park Hotel



Initial Due Diligence

1. Do Informational Audits to Determine the past & current status of SOX 404 Compliance
2. Interview the CFO or Controller
3. Interview CEO
4. Board of Directors
5. Compliance Officer

ACC's 2005 Annual Meeting: Legal Underdog to Corporate Superhero—Using Compliance for a Competitive Advantage

October 17-19, Marriott Wardman Park Hotel



Interview the CFO or Controller

- Who is the key person in charge of Audits?
- What is the current status of Audit
- Memo to CFO regarding corporate requirements of SOX 404

ACC's 2005 Annual Meeting: Legal Underdog to Corporate Superhero—Using Compliance for a Competitive Advantage

October 17-19, Marriott Wardman Park Hotel



Interview Certifying Officers

- Certification
- Involvement
- Record keeping



Board of Directors

- Audit Committee
 - Audit Committee Chairman
- Disclosure Committee



Interview External Auditors, Accountants, Advisors & Attorneys

1. Determine who the companies external advisors are, if any.
2. Does the Audit Committee or the board have its own legal and financial consultants and advisors?
3. Which, if any external advisors should legal meet with?

ACC's 2005 Annual Meeting: Legal Underdog to Corporate Superhero—Using Compliance for a Competitive Advantage

October 17-19, Marriott
Wardman Park Hotel



Which, if any external advisors should legal meet with?

1. Auditors
2. Any concern with regard to limitation of conversation?
3. Should legal meet with auditors in the presence of CFO or Controller or out of their presence?
4. Should legal, review Auditor qualifications?

ACC's 2005 Annual Meeting: Legal Underdog to Corporate Superhero—Using Compliance for a Competitive Advantage

October 17-19, Marriott
Wardman Park Hotel



Determine Legal Department Involvement & Responsibilities

Law

Attitude & Cooperation of Key Internal Personnel

Budget & Availability of outside legal and other consultants

ACC's 2005 Annual Meeting: Legal Underdog to Corporate Superhero—Using Compliance for a Competitive Advantage

October 17-19, Marriott Wardman Park Hotel



Ongoing Compliance

- What are Sox 404 Ongoing Requirements?
 - Quarterly evaluations of ICFR with CEO & CFO involvement.
- What is the relationship between Internal Controls over Financial Reporting (ICFR) and Disclosure Controls & Procedures?
- Risk Assessment Audit

ACC's 2005 Annual Meeting: Legal Underdog to Corporate Superhero—Using Compliance for a Competitive Advantage

October 17-19, Marriott Wardman Park Hotel



Remediation

- Management
 - What to do if "Management" discovers a Material Weakness?
 - What to do if "Management" discovers a Significant Deficiency"?
- Auditor
 - What to do if Auditor discovers a Material Weakness?
 - What to do if Auditor discovers a Significant Deficiency"?



Other Considerations

- Foreign Subsidiaries
- Mergers & Acquisitions
- Vendors & Outsourcing



WHAT DID WE LEARN FROM THE FIRST YEAR

- Early & Often
- Anticipate Issues
- Education
- Communicate Often

SEC. 404. MANAGEMENT ASSESSMENT OF INTERNAL CONTROLS.

(a) RULES REQUIRED.—The Commission shall prescribe rules requiring each annual report required by section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m or 78o(d)) to contain an internal control report, which shall—

(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

(2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

(b) INTERNAL CONTROL EVALUATION AND REPORTING.—With respect to the internal control assessment required by subsection (a), each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

Final Rule: Management's Report on Internal Control over Financial Reporting in Exchange Act Periodic Reports; Rel. No. 33-8392, February 24, 2004

Final Rule: Management's Report on Internal Control over Financial Reporting in Exchange Act Periodic Reports; Rel. No. 33-8392, February 24, 2004



[Home](#) | [Previous Page](#)

U.S. Securities and Exchange Commission

Final Rule:

Management's Report on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 210, 228, 229, 240, 249, 270 and 274

[RELEASE NOS. 33-8392; 34-49313; IC-26357; File Nos. S7-40-02; S7-06-03]

RIN 3235-AI66 and 3235-AI79

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND CERTIFICATION OF DISCLOSURE IN EXCHANGE ACT PERIODIC REPORTS

AGENCY: Securities and Exchange Commission.

ACTION: Final rule; extension of compliance dates.

SUMMARY: We are extending the compliance dates that were published on June 18, 2003 in Release No. 33-8238 [68 FR 36636] for certain amendments to Rules 13a-15 and 15d-15 under the Securities Exchange Act of 1934, Items 308(a) and (b) of Regulations S-K and S-B and the corresponding provisions in Forms 20-F and 40-F, that require companies, other than registered investment companies, to include in their annual reports a report of management on the company's internal control over financial reporting, and to evaluate, as of the end of each fiscal period, any change in the company's internal control over financial reporting that occurred during the period that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting. We are also extending the compliance dates for amendments to certain representations that must be included in the certifications required by Exchange Act Rules 13a-14 and 15d-14 and Investment Company Act of 1940 Rule 30a-2, regarding the company's internal control over financial reporting. The companies subject to these certification provisions include registered investment companies. Finally, we are extending the compliance date for an amendment to Investment Company Act Rule 30a-3 regarding the maintenance of internal control over financial reporting.

DATES: Effective Date: The effective date published on June 18, 2003, remains August 14, 2003.

Compliance Dates: The compliance dates are extended as follows: A company that is an "accelerated filer," as defined in Exchange Act Rule 12b-2, must begin to comply with the management report on internal control over financial reporting requirement and the related registered public accounting firm report requirement in Items 308(a) and (b) of Regulations S-K and S-B for its first fiscal year ending on or after November 15, 2004. A non-accelerated filer must begin to comply with these requirements for its first fiscal year ending on or after July 15, 2005. A foreign private issuer that files its annual report on Form 20-F or Form 40-F must begin to comply with the corresponding requirements in these forms for its first fiscal year ending on or after July 15, 2005.

A company must begin to comply with the provisions of Exchange Act Rule 13a-15(d) or 15d-15(d), whichever applies, requiring an evaluation of changes to internal control over financial reporting requirements with respect to the company's first periodic report due after the first annual report that must include management's report on internal control over financial reporting.

In addition, we are applying the extended compliance period to the amended portion of the introductory language in paragraph 4 of the certification required by Exchange Act Rules 13a-14(a) and 15d-14(a) that refers to the certifying officers' responsibility for establishing and maintaining internal control over financial reporting for the company, as well as paragraph 4(b). The amended language must be provided in the first annual report required to contain management's internal control report and in all periodic reports filed thereafter. The extended compliance dates also apply to the amendments of Exchange Act Rules 13a-15(a) and 15d-15(a) relating to the maintenance of internal control over financial reporting.

We are also extending the compliance period for registered investment companies to comply with the amended portion of the introductory language in paragraph 4 of the certification in Form N-CSR required by Investment Company Act Rule 30a-2(a) that refers to the certifying officers' responsibility for establishing and maintaining internal control over financial reporting for the company, as well as paragraph 4(b) of the certification in Form N-CSR. The amended language must be provided beginning with the first annual report filed on Form N-CSR for a fiscal year ending on or after November 15, 2004.¹ Registered investment companies must comply with the amendment to Investment Company Act Rule 30a-3(a) relating to the maintenance of internal control over financial reporting with respect to fiscal years ending on or after November 15, 2004.

The extended compliance period does not in any way affect the provisions of our other rules and regulations regarding internal controls that are in effect, including, without limitation, Exchange Act Rule 13b2-2.

FOR FURTHER INFORMATION CONTACT: Sean Harrison, Special Counsel,

Final Rule: Management's Report on Internal Control over Financial Reporting in Exchange Act Periodic Reports; Rel. No. 33-8392, February 24, 2004

Division of Corporation Finance, at (202) 942-2910, or with respect to registered investment companies, Christian Broadbent, Senior Counsel, Division of Investment Management, at (202) 942-0721, U.S. Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: On June 5, 2003,² the Commission adopted amendments to Items 307, 401 and 601 of Regulations S-B³ and S-K;⁴ added new Item 308 to Regulations S-B and S-K; amended Form 10-K,⁵ Form 10-KSB,⁶ Form 10-Q,⁷ Form 10-QSB,⁸ Form 20-F,⁹ Form 40-F,¹⁰ Rule 12b-15,¹¹ Rule 13a-14,¹² Rule 13a-15,¹³ Rule 15d-14¹⁴ and Rule 15d-15¹⁵ under the Securities Exchange Act of 1934;¹⁶ amended Rules 1-02 and 2-02¹⁷ of Regulation S-X;¹⁸ amended Rules 8b-15,¹⁹ 30a-2²⁰ and 30a-3²¹ under the Investment Company Act of 1940;²² and amended Forms N-CSR²³ and N-SAR²⁴ under the Exchange Act and the Investment Company Act. Among other things, these amendments require companies, other than registered investment companies, to include in their annual reports a report of management on the company's internal control over financial reporting, and to evaluate, as of the end of each fiscal quarter, or year in the case of a foreign private issuer filing its annual report on Form 20-F or 40-F, any change in the company's internal control over financial reporting that occurred during the period that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

In our June 2003 Adopting Release, we decided to provide a lengthy compliance period for the amendments requiring a report by management on a company's internal control over financial reporting. Specifically, we provided that a company that was an accelerated filer would have to begin complying with the new amendments in its annual report for its first fiscal year ending on or after June 15, 2004, and that a non-accelerated filer would have to begin complying in its annual report for its first fiscal year ending on or after April 15, 2005. We stated that a longer transition period was appropriate in light of both the substantial time and resources needed by companies to properly implement the rules, and the corresponding benefit to investors that would result from companies' proper implementation of the new requirements. We further noted that a longer transition period would provide additional time for the Public Company Accounting Oversight Board (the "PCAOB") to consider relevant factors in determining and implementing new standards for registered public accounting firms.²⁵ The PCAOB made a determination to set new standards and has been working expeditiously to do so. It held a public roundtable in July 2003 to discuss significant issues associated with the establishment of a new standard and issued a proposed standard on October 7, 2003.²⁶ The PCAOB received nearly 200 comment letters on the proposals and has completed its review and analysis of the public comment.

On January 23, 2004, representatives of five companies requested that the Commission extend the June 15, 2004 compliance date for accelerated

Final Rule: Management's Report on Internal Control over Financial Reporting in Exchange Act Periodic Reports; Rel. No. 33-8392, February 24, 2004

filers.²⁷ In their request, these companies argued that it would be extremely difficult for companies to properly prepare for compliance with the new internal control over financial reporting requirements, and for auditors to properly implement a new standard that has not yet been finalized, for a fiscal year that is nearly complete. They further asserted that companies with June, July and August fiscal year ends that are in the process of documenting and evaluating controls have based these processes on the PCAOB's proposed standard. Several commenters on the PCAOB's proposed standard expressed similar concerns and requested that the Commission and the PCAOB provide additional time for compliance.²⁸

We believe that an extension of compliance dates for the internal control reporting over financial reporting requirements is appropriate. We believe that the extension will benefit investors because this will help ensure that appropriate controls are in place for the first reporting process. Moreover, an extension will minimize the cost and disruption of implementing a new disclosure requirement under a current standard that will soon be superseded, and will provide companies and their auditors with a sufficient amount of time to perform additional testing or remediation of controls based on the final standard. We also, for good cause, find that, based on the reasons cited above, notice and solicitation of comment regarding extension of the compliance dates is impracticable, unnecessary, and contrary to the public interest.²⁹ In addition, for good cause and because the extension will relieve a restriction, the extension will be effective on March 1, 2004.

By the Commission.

Margaret H. McFarland
Deputy Secretary

February 24, 2004

-
- ¹ The amended language must also be provided in reports on Form N-Q following this report on Form N-CSR. On February 11, 2004, the Commission indicated that it would issue a release adopting rules that will require a registered management investment company to file its portfolio holdings with the Commission on Form N-Q not later than 60 days after the close of the first and third quarters of each fiscal year.
 - ² See Release No. 33-8238 (June 5, 2003) [68 FR 36636] (the "Adopting Release").
 - ³ 17 CFR 228.10 *et seq.*
 - ⁴ 17 CFR 229.10 *et seq.*
 - ⁵ 17 CFR 249.310.
 - ⁶ 17 CFR 249.310b.
 - ⁷ 17 CFR 249.308a.

Final Rule: Management's Report on Internal Control over Financial Reporting in Exchange Act Periodic Reports; Rel. No. 33-8392, February 24, 2004

- [8](#) 17 CFR 249.308b.
- [9](#) 17 CFR 249.220f.
- [10](#) 17 CFR 249.240f.
- [11](#) 17 CFR 240.12b-15.
- [12](#) 17 CFR 240.13a-14.
- [13](#) 17 CFR 240.13a-15.
- [14](#) 17 CFR 140.15d-14.
- [15](#) 17 CFR 240.15d-15.
- [16](#) 15 U.S.C. 78a *et seq.*
- [17](#) 17 CFR 210.1-02 and 2-02.
- [18](#) 17 CFR 210.1-01 *et seq.*
- [19](#) 17 CFR 270.8b-15.
- [20](#) 17 CFR 270.30a-2.
- [21](#) 17 CFR 270.30a-3.
- [22](#) 15 U.S.C. 80a-1 *et seq.*
- [23](#) 17 CFR 249.331; 17 CFR 274.128.
- [24](#) 17 CFR 249.330; 17 CFR 274.101.
- [25](#) Under the Sarbanes-Oxley Act, the PCAOB was granted authority to set auditing and attestation standards for registered public accounting firms to use in the preparation and issuance of audit reports on the financial statements of issuers. Under Section 404(b) of the Act, the PCAOB is required to set standards for registered public accounting firms' attestations to, and reports on, management's assessment regarding its internal control over financial reporting.
- [26](#) See PCAOB Release No. 2003-017, PCAOB Rulemaking Docket Matter No. 008.
- [27](#) See Letter to Mr. William H. Donaldson, Chairman of the Securities and Exchange Commission, and Mr. William J. McDonough, Chairman of the Public Company Accounting Oversight Board, from John G. Connors, Sr. Vice President and Chief Financial Officer, Microsoft Corporation, on behalf of Clayton C. Daley Jr., Chief Financial Officer, Proctor & Gamble; Richard J. Miller, Executive Vice President and Chief Financial Officer, Cardinal Health Corporation; Richard A. Galanti, Executive Vice President and Chief Financial Officer, Costco Wholesale Corporation and Michael J. Irwin, Executive Vice President and Chief Financial Officer, WD-40 Company, dated January 23, 2004.
- [28](#) See letters regarding PCAOB Rulemaking Docket Matter No. 008 of: the American Institute of Certified Public Accountants, Deloitte & Touche LLP, PricewaterhouseCoopers LLP, Walt Disney Corporation and H.W. Willoughby. These letters are available at www.pcaobus.org.
- [29](#) See Section 553(b)(3)(B) of the Administrative Procedure Act [5 U.S.C. 55s(b)(3)(B)] (an agency may dispense with prior notice and comment when it finds, for good cause, that notice and comment are "impracticable, unnecessary, or contrary to the public interest").

Final Rule: Management's Report on Internal Control over Financial Reporting in Exchange Act Periodic Reports; Rel. No. 33-8392, February 24, 2004

<http://www.sec.gov/rules/final/33-8392.htm>

[Home](#) | [Previous Page](#)

Modified: 02/26/2004


[Home](#) | [Previous Page](#)

U.S. Securities and Exchange Commission

Final Rule:

Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 210, 228, 229, 240, 249, 270 and 274

[RELEASE NOS. 33-8238; 34-47986; IC-26068; File Nos. S7-40-02; S7-06-03]

RIN 3235-AI66 and 3235-AI79

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING AND CERTIFICATION OF DISCLOSURE IN EXCHANGE ACT PERIODIC REPORTS

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: As directed by Section 404 of the Sarbanes-Oxley Act of 2002, we are adopting rules requiring companies subject to the reporting requirements of the Securities Exchange Act of 1934, other than registered investment companies, to include in their annual reports a report of management on the company's internal control over financial reporting. The internal control report must include: a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company; management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year; a statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting; and a statement that the registered public accounting firm that audited the company's financial statements included in the annual report has issued an attestation report on management's assessment of the company's internal control over financial reporting. Under the new rules, a company is required to file the registered public accounting firm's attestation report as part of the annual report. Furthermore, we are adding a requirement that management evaluate any change in the company's internal control over financial reporting that occurred during a fiscal quarter that has materially affected, or is reasonably

likely to materially affect, the company's internal control over financial reporting. Finally, we are adopting amendments to our rules and forms under the Securities Exchange Act of 1934 and the Investment Company Act of 1940 to revise the Section 302 certification requirements and to require issuers to provide the certifications required by Sections 302 and 906 of the Sarbanes-Oxley Act of 2002 as exhibits to certain periodic reports.

DATES: Effective Date: August 14, 2003.

Compliance Dates: The following compliance dates apply to companies other than registered investment companies. A company that is an "accelerated filer," as defined in Exchange Act Rule 12b-2, as of the end of its first fiscal year ending on or after June 15, 2004, must begin to comply with the management report on internal control over financial reporting disclosure requirements in its annual report for that fiscal year. A company that is not an accelerated filer as of the end of its first fiscal year ending on or after June 15, 2004, including a foreign private issuer, must begin to comply with the annual internal control report for its first fiscal year ending on or after April 15, 2005. A company must begin to comply with the requirements regarding evaluation of any material change to its internal control over financial reporting in its first periodic report due after the first annual report required to include a management report on internal control over financial reporting. Companies may voluntarily comply with the new disclosure requirements before the compliance dates. A company must comply with the new exhibit requirements for the certifications required by Sections 302 and 906 of the Sarbanes-Oxley Act of 2002 and changes to the Section 302 certification requirements in its quarterly, semi-annual or annual report due on or after August 14, 2003. To account for the differences between the compliance date of the rules relating to internal control over financial reporting and the effective date of changes to the language of the Section 302 certification, a company's certifying officers may temporarily modify the content of their Section 302 certifications to eliminate certain references to internal control over financial reporting until the compliance date, as further explained in Section III.E. below.

Registered investment companies must comply with the rule and form amendments applicable to them on and after August 14, 2003, except as follows. Registered investment companies must comply with the amendments to Exchange Act Rules 13a-15(a) and 15d-15(a) and Investment Company Act Rule 30a-3(a) that require them to maintain internal control over financial reporting with respect to fiscal years ending on or after June 15, 2004. In addition, a registered investment company's certifying officers may temporarily modify the content of their Section 302 certifications to eliminate certain references to internal control over financial reporting, as further explained in Section II.I. below. Registered investment companies may voluntarily comply with the rule and form amendments before the compliance dates.

FOR FURTHER INFORMATION CONTACT: N. Sean Harrison, Special Counsel, or Andrew D. Thorpe, Special Counsel, Division of Corporation Finance, at (202) 942-2910, or with respect to registered investment

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

companies, Christian Broadbent, Senior Counsel, Division of Investment Management, at (202) 942-0721, or with respect to attestation and auditing issues, Edmund Bailey, Assistant Chief Accountant, Randolph P. Green, Professional Accounting Fellow, or Paul Munter, Academic Accounting Fellow, Office of the Chief Accountant, at (202) 942-4400, U.S. Securities and Exchange Commission, 450 Fifth Street, NW, Washington, DC 20549.

SUPPLEMENTARY INFORMATION: We are revising Items 307, 401 and 601 of Regulations S-B¹ and S-K;² adding new Item 308 to Regulations S-B and S-K; amending Form 10-K,³ Form 10-KSB,⁴ Form 10-Q,⁵ Form 10-QSB,⁶ Form 20-F,⁷ Form 40-F,⁸ Rule 12b-15,⁹ Rule 13a-14,¹⁰ Rule 13a-15,¹¹ Rule 15d-14¹² and Rule 15d-15¹³ under the Securities Exchange Act of 1934 (the "Exchange Act");¹⁴ amending Rules 1-02 and 2-02¹⁵ of Regulation S-X;¹⁶ amending Rules 8b-15,¹⁷ 30a-2¹⁸ and 30a-3¹⁹ under the Investment Company Act of 1940 ("Investment Company Act");²⁰ and amending Forms N-CSR²¹ and N-SAR²² under the Exchange Act and the Investment Company Act.

TABLE OF CONTENTS

I. BACKGROUND

- A. Management's Report on Internal Control over Financial Reporting
- B. Certifications

II. DISCUSSION OF AMENDMENTS IMPLEMENTING SECTION 404

- A. Definition of Internal Control
 - 1. Proposed Rule
 - 2. Comments on the Proposal
 - 3. Final Rules
- B. Management's Annual Assessment of, and Report on, the Company's Internal Control over Financial Reporting
 - 1. Proposed Rule
 - 2. Comments on the Proposal

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

3. Final Rules

- a. Evaluation of Internal Control over Financial Reporting
- b. Auditor Independence Issues
- c. Material Weaknesses in Internal Control over Financial Reporting
- d. Method of Evaluating
- e. Location of Management's Report

C. Quarterly Evaluations of Internal Control over Financial Reporting

- 1. Proposed Rule
- 2. Comments on the Proposal
- 3. Final Rules

D. Differences between Internal Control over Financial Reporting and Disclosure Controls and Procedures

E. Evaluation of Disclosure Controls and Procedures

F. Periodic Disclosure about the Certifying Officers' Evaluation of the Company's Disclosure Controls and Procedures and Disclosure about Changes to its Internal Control over Financial Reporting

- 1. Existing Disclosure Requirements
- 2. Proposed Amendments to the Disclosure Requirements
- 3. Final Disclosure Requirements
- 4. Conclusions Regarding Effectiveness of Disclosure Controls and Procedures

G. Attestation to Management's Internal Control Report by the Company's Registered Public Accounting Firm

H. Types of Companies Affected

1. [Foreign Private Issuers](#)
2. [Asset-Backed Issuers](#)
3. [Small Business Issuers](#)
4. [Bank and Thrift Holding Companies](#)

I. [Registered Investment Companies](#)

J. [Transition Period](#)

III. [DISCUSSION OF AMENDMENTS RELATED TO CERTIFICATIONS](#)

A. [Proposed Rules](#)

B. [Final Rules](#)

C. [Effect on Interim Guidance Regarding Filing Procedures](#)

D. [Form of Section 302 Certifications](#)

E. [Transition Period](#)

IV. [PAPERWORK REDUCTION ACT](#)

V. [COST-BENEFIT ANALYSIS](#)

VI. [EFFECT ON EFFICIENCY, COMPETITION AND CAPITAL FORMATION](#)

VII. [FINAL REGULATORY FLEXIBILITY ANALYSIS](#)

VIII. [STATUTORY AUTHORITY AND TEXT OF RULE AMENDMENTS](#)

I. BACKGROUND

A. Management's Report on Internal Control over Financial Reporting

In this release, we implement Section 404 of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act"),²³ which requires us to prescribe rules requiring each annual report that a company, other than a registered investment company,²⁴ files pursuant to Section 13(a) or 15(d) of the Exchange Act to contain an internal control report: (1) stating management's responsibility for establishing and maintaining an adequate internal control structure and

procedures for financial reporting; and (2) containing an assessment, as of the end of the company's most recent fiscal year, of the effectiveness of the company's internal control structure and procedures for financial reporting. Section 404 also requires every registered public accounting firm that prepares or issues an audit report on a company's annual financial statements to attest to, and report on, the assessment made by management. The attestation must be made in accordance with standards for attestation engagements issued or adopted by the Public Company Accounting Oversight Board ("PCAOB").²⁵ Section 404 further stipulates that the attestation cannot be the subject of a separate engagement of the registered public accounting firm.

We received over 200 comment letters in response to our release proposing requirements to implement Sections 404, 406 and 407 of the Sarbanes-Oxley Act.²⁶ Of these, 61 respondents commented on the Section 404 proposals.²⁷ These comment letters came from corporations, professional associations, accountants, law firms, consultants, academics, investors and others. In general, the commenters supported the objectives of the proposed new requirements. Investors supported the manner in which we proposed to achieve these objectives and, in some cases, urged us to require additional disclosure from companies. Other commenters, however, thought that we were requiring more disclosure than necessary to fulfill the mandates of the Sarbanes-Oxley Act and suggested modifications to the proposals. We have reviewed and considered all of the comments that we received on the proposals. The adopted rules reflect many of these comments -- we discuss our conclusions with respect to each topic and related comments in more detail throughout the release.

B. Certifications

We also are adopting amendments to require companies to file the certifications mandated by Sections 302 and 906 of the Sarbanes-Oxley Act as exhibits to annual, semi-annual and quarterly reports. Section 302 required the Commission to adopt final rules that were to be effective by August 29, 2002, under which the principal executive and principal financial officers, or persons performing similar functions, of a company filing periodic reports under Section 13(a) or 15(d) of the Exchange Act²⁸ must provide a certification in each quarterly and annual report filed with the Commission. Section 906 of the Sarbanes-Oxley Act added new Section 1350 to Title 18 of the United States Code,²⁹ which contains a certification requirement subject to specific federal criminal provisions and that is separate and distinct from the certification requirement mandated by Section 302.³⁰ On August 28, 2002, we adopted Exchange Act Rules 13a-14 and 15d-14 and Investment Company Act Rule 30a-2 and amended our periodic report forms to implement the statutory directive in Section 302.³¹ These rules and amendments became effective on August 29, 2002. On January 27, 2003, we adopted Form N-CSR to be used by registered management investment companies to file certified shareholder reports with the Commission.³² The provisions added to Title 18 by Section 906 were by their terms effective on

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

enactment of the Sarbanes-Oxley Act.

To enhance the ability of interested parties to effectively access the certifications through our Electronic Data Gathering, Analysis and Retrieval ("EDGAR") system and thereby enhance compliance with the certification requirements, we proposed to amend our rules and forms to require a company to file the certifications as an exhibit to the periodic reports to which they relate.³³ The proposals addressed both Section 302 and 906 certifications. After discussions with the Department of Justice, we concluded that, in light of the inconsistent methods that companies have been employing to fulfill their obligations under Section 906,³⁴ an exhibit requirement would consistently enable investors and the Commission staff, as well as the Department of Justice, to more effectively monitor compliance with this certification requirement.

II. DISCUSSION OF AMENDMENTS IMPLEMENTING SECTION 404

A. Definition of Internal Control

1. Proposed Rule

The proposed rules would have defined the term "internal controls and procedures for financial reporting"³⁵ to mean controls that pertain to the preparation of financial statements for external purposes that are fairly presented in conformity with generally accepted accounting principles as addressed by the Codification of Statements on Auditing Standards §319 or any superseding definition or other literature that is issued or adopted by the Public Company Accounting Oversight Board.

As noted in the Proposing Release, there has been some confusion over the exact meaning and scope of the term "internal control," because the definition of the term has evolved over time. Historically, the term "internal control" was applied almost exclusively within the accounting profession.³⁶ As the auditing of financial statements evolved from a process of detailed testing of transactions and account balances towards a process of sampling and testing, greater consideration of a company's internal controls became necessary in planning an audit.³⁷ If an internal control component had been adequately designed, then the auditor could limit further consideration of that control to procedures to determine whether the control had been placed in operation. Accordingly, the auditor could rely on the control to serve as a basis to reduce the amount, timing or extent of substantive testing in the execution of an audit. Conversely, if an auditor determined that an internal control component was inadequate in its design or operation, then the auditor could not rely upon that control. In this instance, the auditor would conduct tests of transactions and perform additional analyses in order to accumulate sufficient, competent audit evidence to support its opinion on the financial statements.

From the outset, it was recognized that internal control is a broad concept

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

that extends beyond the accounting functions of a company. Early attempts to define the term focused primarily on clarifying the portion of a company's internal control that an auditor should consider when planning and performing an audit of a company's financial statements.³⁸ However, this did not improve the level of understanding of the term, nor satisfactorily provide the guidance sought by auditors. Successive definitions and formal studies of the concept of internal control followed.

In 1977, based on recommendations of the Commission, Congress enacted the Foreign Corrupt Practices Act ("FCPA").³⁹ The FCPA codified the accounting control provisions contained in Statement of Auditing Standards No. 1 (codified as AU §320 in the Codification of Statements on Auditing Standards). Under the FCPA, companies that have a class of securities registered under Section 12 of the Exchange Act, or that are required to file reports under Section 15(d) of the Exchange Act, are required to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that:

- transactions are executed in accordance with management's general or specific authorization;
- transactions are recorded as necessary (1) to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (2) to maintain accountability for assets;
- access to assets is permitted only in accordance with management's general or specific authorization; and
- the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.⁴⁰

In 1985, a private-sector initiative known as the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission, was formed to study the financial reporting system in the United States. In 1987, the Treadway Commission issued a report recommending that its sponsoring organizations work together to integrate the various internal control concepts and definitions and to develop a common reference point.

In response, the Committee of Sponsoring Organizations of the Treadway Commission ("COSO")⁴¹ undertook an extensive study of internal control to establish a common definition that would serve the needs of companies, independent public accountants, legislators and regulatory agencies, and to provide a broad framework of criteria against which companies could evaluate the effectiveness of their internal control systems. In 1992, COSO published its Internal Control -- Integrated Framework.⁴² The COSO Framework defined internal control as "a process, effected by an entity's

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives" in three categories--effectiveness and efficiency of operations; reliability of financial reporting; and compliance with applicable laws and regulations. COSO further stated that internal control consists of: the control environment, risk assessment, control activities, information and communication, and monitoring. The scope of internal control therefore extends to policies, plans, procedures, processes, systems, activities, functions, projects, initiatives, and endeavors of all types at all levels of a company.

In 1995, the AICPA incorporated the definition of internal control set forth in the COSO Report in Statement on Auditing Standards No. 78 (codified as AU §319 in the Codification of Statements on Auditing Standards).⁴³ Although we recognized that the AU §319 definition was derived from the COSO definition, our proposal referred to AU §319 because we thought that the former constituted a more formal and widely-accessible version of the definition than the latter.

2. Comments on the Proposal

We received comments from 25 commenters on the proposed definition of "internal control and procedures for financial reporting." Eleven commenters stated that the proposed definition of internal control was appropriate or generally agreed with the proposal.⁴⁴ Two of these noted that the definition in AU §319 had been adopted by the bank regulatory agencies for use by banking institutions.⁴⁵ Fourteen of the 25 commenters opposed the proposed definition. Two of these asserted that the proposed definition was too complex and would not resolve the confusion that existed over the meaning or scope of the term.

Several of the commenters that were opposed to the proposed definition thought that we should refer to COSO for the definition of internal control, rather than AU §319.⁴⁶ Some of these commenters noted that the objective of AU §319 is to provide guidance to auditors regarding their consideration of internal control in planning and performing an audit of financial statements. The common concern of these commenters was that AU §319 does not provide any measure or standard by which a company's management can determine that internal control is effective, nor does it define what constitutes effective internal control. One commenter believed that absent such evaluative criteria or definition of effectiveness, the proposed rules could not be implemented effectively.⁴⁷ In addition, several of the commenters opposed to the proposed definition suggested that we use the term "internal control over financial reporting" rather than the term "internal controls and procedures for financial reporting,"⁴⁸ on the ground that the former is more consistent with the terminology currently used within the auditing literature.

A few of the commenters urged us to adopt a considerably broader definition of internal control that would focus not only on internal control over financial

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

reporting, but also on internal control objectives associated with enterprise risk management and corporate governance. While we agree that these are important objectives, the definition that we are adopting retains a focus on financial reporting, consistent with our position articulated in the Proposing Release. We are not adopting a more expansive definition of internal control for a variety of reasons. Most important, we believe that Section 404 focuses on the element of internal control that relates to financial reporting. In addition, many commenters indicated that even the more limited definition related to financial reporting that we proposed will impose substantial reporting and cost burdens on companies. Finally, independent accountants traditionally have not been responsible for reviewing and testing, or attesting to an assessment by management of, internal controls that are outside the boundary of financial reporting.

3. Final Rules

After consideration of the comments, we have decided to make several modifications to the proposed amendments. We agree that we should use the term "internal control over financial reporting" in our amendments to implement Section 404, as well as our revisions to the Section 302 certification requirements and forms of certification.⁴⁹ Rapidly changing terminology has been one obstacle in the development of an accepted understanding of internal control. The term "internal control over financial reporting" is the predominant term used by companies and auditors and best encompasses the objectives of the Sarbanes-Oxley Act. In addition, by using this term, we avoid having to familiarize investors, companies and auditors with new terminology, which should lessen any confusion that may exist about the meaning and scope of internal control.

The final rules define "internal control over financial reporting" as:

A process designed by, or under the supervision of, the registrant's principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant's board of directors,⁵⁰ 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:

- (1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrant;
- (2) 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

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

of the registrant are being made only in accordance with authorizations of management and directors of the registrant; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements.⁵¹

We recognize that our definition of the term "internal control over financial reporting" reflected in the final rules encompasses the subset of internal controls addressed in the COSO Report that pertains to financial reporting objectives. Our definition does not encompass the elements of the COSO Report definition that relate to effectiveness and efficiency of a company's operations and a company's compliance with applicable laws and regulations, with the exception of compliance with the applicable laws and regulations directly related to the preparation of financial statements, such as the Commission's financial reporting requirements.⁵² Our definition is consistent with the description of internal accounting controls in Exchange Act Section 13(b)(2)(B).⁵³

Following the general language defining internal control over financial reporting, clauses (1) and (2) include the internal control matters described in Section 103 of the Sarbanes-Oxley Act that the company's registered public accounting firm is required to evaluate in its audit or attestation report.⁵⁴ This language is included to make clear that the assessment of management in its internal control report as to which the company's registered public accounting firm will be required to attest and report specifically covers the matters referenced in Section 103. A few commenters believed that it would cause confusion if the definition of internal control did not acknowledge the objectives set forth in Section 103 of the Sarbanes-Oxley Act. As discussed in Section II.G below, the PCAOB is responsible for establishing the Section 103 standards.

Our definition also includes, in clause (3), explicit reference to assurances regarding use or disposition of the company's assets. This provision is specifically included to make clear that, for purposes of our definition, the safeguarding of assets is one of the elements of internal control over financial reporting and it addresses the supplementation of the COSO Framework after it was originally promulgated. In the absence of our change to the definition, the determination of whether control regarding the safeguarding of assets falls within a company's internal control over financial reporting currently could be subject to varying interpretation.

Safeguarding of assets had been a primary objective of internal accounting control in SAS No. 1. In 1988, the ASB issued Statement of Auditing Standards No. 55 (codified as AU §319 in the Codification of Statements on Auditing Standards), which replaced AU §320. SAS No. 55 revised the definition of "internal control" and expanded auditors' responsibilities for

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

considering internal control in a financial statement audit. The prior classification of internal control into the two categories of "internal accounting control" and "administrative control" was replaced with the single term "internal control structure," which consisted of three interrelated components--control environment, the accounting system and control procedures. Under this new definition, the safeguarding of assets was no longer a primary objective, but a subset of the control procedures component.⁵⁵ The COSO Report followed this shift in the iteration of safeguarding of assets. The COSO Report states that operations objectives "pertain to effectiveness and efficiency of the entity's operations, including performance and profitability goals and safeguarding resources against loss."⁵⁶ However, the report also clarifies that safeguarding of assets can fall within other categories of internal control.⁵⁷

In 1994, COSO published an addendum to the Reporting to External Parties volume of the COSO Report. The addendum was issued in response to a concern expressed by some parties, including the U.S. General Accounting Office, that the management reports contemplated by the COSO Report did not adequately address controls relating to safeguarding of assets and therefore would not fully respond to the requirements of the FCPA.⁵⁸ In the addendum, COSO concluded that while it believed its definition of internal control in its 1992 report remained appropriate, it recognized that the FCPA encompasses certain controls related to safeguarding of assets and that there is a reasonable expectation on the part of some readers of management's internal control reports that the reports will cover such controls. The addendum therefore sets forth the following definition of the term "internal control over safeguarding of assets against unauthorized acquisition, use or disposition":

Internal control over safeguarding of assets against unauthorized acquisition, use or disposition is a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the entity's assets that could have a material effect on the financial statements.

As indicated above, to achieve the desired result and to provide consistency with COSO's 1994 addendum, we have incorporated this definition into our definition of "internal control over financial reporting." We are persuaded that this is appropriate given the fact that our definition will be used for purposes of public management reporting, and that the companies that will be subject to the Section 404 requirements also are subject to the FCPA requirements. So, under the final rules, safeguarding of assets as provided is specifically included in our definition of "internal control over financial reporting."

B. Management's Annual Assessment of, and Report on, the Company's Internal Control over Financial Reporting

1. Proposed Rule

We proposed to amend Item 307 of Regulations S-K and S-B, as well as Forms 20-F and 40-F, to require a company's annual report to include an internal control report of management containing:

- A statement of management's responsibility for establishing and maintaining adequate internal controls and procedures for financial reporting;
- The conclusions of management about the effectiveness of the company's internal controls and procedures for financial reporting based on management's evaluation of those controls and procedures; and
- A statement that the registered public accounting firm that prepared or issued the company's audit report relating to the financial statements included in the company's annual report has attested to, and reported on, management's evaluation of the company's internal controls and procedures for financial reporting.

The proposed amendments did not list any additional disclosure requirements for the management report, but rather would have afforded management the flexibility to tailor the report to fit its company's particular circumstances.

2. Comments on the Proposal

We received comments from 17 commenters on our proposed annual internal control report requirements. All of these commenters believed, in varying degrees, that we should set forth additional disclosure criteria or standards for the management report. Nine commenters stated that we should provide guidance as to the topics to be addressed in the management report, or specify standards or a common set of internal control objectives to be considered by management when assessing the effectiveness of its company's internal control over financial reporting to ensure that control objectives are addressed in a consistent fashion.⁵⁹ These commenters believed that consistent standards for management's report on internal control would help investors to understand and compare the quality of various management internal control reports.

Several commenters also thought that we should require management's internal control report to include certain recitations that would parallel recitations that the registered public accounting firm would have to make in its report attesting to management's assessment.⁶⁰ Additional commenters believed that the management report on internal control should specifically reference the objectives contained in Section 103 of the Sarbanes-Oxley Act.⁶¹ Furthermore, although Section 404(b) of the Sarbanes-Oxley Act does not explicitly direct us to require companies to file the registered public accounting firms' attestation reports as part of the companies' annual report filings, we proposed a filing requirement that most of those commenting on

this aspect of the proposal supported.

3. Final Rules

After evaluating the comments received, we are adopting the proposals with several modifications. The final rules require a company's annual report to include an internal control report of management that contains:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company;
- A statement identifying the framework used by management to conduct the required evaluation of the effectiveness of the company's internal control over financial reporting;
- Management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including a statement as to whether or not the company's internal control over financial reporting is effective.⁶² The assessment must include disclosure of any "material weaknesses"⁶³ in the company's internal control over financial reporting identified by management. Management is not permitted to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses in the company's internal control over financial reporting; and
- A statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the registrant's internal control over financial reporting.⁶⁴

As proposed, our final rules also require a company to file, as part of the company's annual report, the attestation report of the registered public accounting firm that audited the company's financial statements.

a. Evaluation of Internal Control over Financial Reporting

In the Proposing Release, we requested comment on whether we should establish specific evaluative criteria for management's report on internal control. All of the commenters responding to this request supported the establishment of such evaluative criteria in order to improve comparability among the standards used by companies to conduct their annual internal control evaluations.⁶⁵ Several commenters believed that we either should adopt the COSO Framework as the means by which management must evaluate its company's internal control over financial reporting or, alternatively, simply acknowledge the COSO Framework as being suitable for purposes of management's evaluation. Other commenters suggested that we

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

require management to evaluate the effectiveness of a company's internal control over financial reporting using suitable control criteria established by a group that follows due process procedures.

After consideration of the comments, we have modified the final requirements to specify that management must base its evaluation of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment.⁶⁶

The COSO Framework satisfies our criteria and may be used as an evaluation framework for purposes of management's annual internal control evaluation and disclosure requirements. However, the final rules do not mandate use of a particular framework, such as the COSO Framework, in recognition of the fact that other evaluation standards exist outside of the United States,⁶⁷ and that frameworks other than COSO may be developed within the United States in the future, that satisfy the intent of the statute without diminishing the benefits to investors. The use of standard measures that are publicly available will enhance the quality of the internal control report and will promote comparability of the internal control reports of different companies. The final rules require management's report to identify the evaluation framework used by management to assess the effectiveness of the company's internal control over financial reporting.⁶⁸

Specifically, a suitable framework must: be free from bias; permit reasonably consistent qualitative and quantitative measurements of a company's internal control; be sufficiently complete so that those relevant factors that would alter a conclusion about the effectiveness of a company's internal controls are not omitted; and be relevant to an evaluation of internal control over financial reporting.⁶⁹

b. Auditor Independence Issues

Because the auditor is required to attest to management's assessment of internal control over financial reporting, management and the company's independent auditors will need to coordinate their processes of documenting and testing the internal controls over financial reporting. However, we remind companies and their auditors that the Commission's rules on auditor independence prohibit an auditor from providing certain nonaudit services to an audit client.⁷⁰ As the Commission stated in its auditor independence release, auditors may assist management in documenting internal controls. When the auditor is engaged to assist management in documenting internal controls, management must be actively involved in the process. We understand the need for coordination between management and the auditor, however, we remind companies and auditors that management cannot delegate its responsibility to assess its internal controls over financial reporting to the auditor.⁷¹ The rules adopted today do not amend the Commission's rules on auditor independence.

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

c. Material Weaknesses in Internal Control over Financial Reporting

In the Proposing Release, we did not propose any specific standard on which management would base its conclusion that the company's internal control over financial reporting is effective. We requested comment on whether we should prescribe specific standards upon which an effectiveness determination would be based, and also what standards we should consider. Several commenters agreed that the final rules should specify standards, and all believed that the existence of a material weakness in internal control over financial reporting should preclude a conclusion by management that a registrant's internal control over financial reporting is effective. We have considered these comments, and agree that the rules should set forth this threshold for concluding that a company's internal control over financial reporting is effective.

The final rules therefore preclude management from determining that a company's internal control over financial reporting is effective if it identifies one or more material weaknesses in the company's internal control over financial reporting.⁷² For purposes of the final rules, the term "material weakness" has the same meaning as in the definition under GAAS and attestation standards.⁷³ The final rules also specify that management's report must include disclosure of any "material weakness" in the company's internal control over financial reporting identified by management in the course of its evaluation.⁷⁴

d. Method of Evaluating

Many commenters addressed the method of evaluating internal control over financial reporting, and some sought additional precision or guidance regarding the extent of evaluation, including the documentation required.⁷⁵ The methods of conducting evaluations of internal control over financial reporting will, and should, vary from company to company. Therefore, the final rules do not specify the method or procedures to be performed in an evaluation. However, in conducting such an evaluation and developing its assessment of the effectiveness of internal control over financial reporting, a company must maintain evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of the company's internal control over financial reporting. Developing and maintaining such evidential matter is an inherent element of effective internal controls.⁷⁶ An instruction to new Item 308 of Regulations S-K and S-B and Forms 20-F and 40-F reminds registrants to maintain such evidential matter.⁷⁷

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

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

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; and controls related to the prevention, identification, and detection of fraud. The nature of a company's testing activities will largely depend on the circumstances of the company and the significance of the control. However, inquiry alone generally will not provide an adequate basis for management's assessment.⁷⁸

An assessment of the effectiveness of internal control over financial reporting must be supported by evidential matter, including documentation, regarding both the design of internal controls and the testing processes. This evidential matter should provide reasonable support: for the evaluation of whether the control is designed to prevent or detect material misstatements or omissions; for the conclusion that the tests were appropriately planned and performed; and that the results of the tests were appropriately considered. The public accounting firm that is required to attest to, and report on, management's assessment of the effectiveness of the company's internal control over financial reporting also will require that the company develop and maintain such evidential matter to support management's assessment.⁷⁹

e. Location of Management's Report

Although the final rules do not specify where management's internal control report must appear in the company's annual report, we think it is important for management's report to be in close proximity to the corresponding attestation report issued by the company's registered public accounting firm. We expect that many companies will choose to place the internal control report and attestation report near the companies' MD&A disclosure or in a portion of the document immediately preceding the companies' financial statements.

C. Quarterly Evaluations of Internal Control over Financial Reporting

1. Proposed Rule

We proposed to require a company's certifying officers to evaluate the effectiveness of the company's internal controls and procedures for financial reporting as of the end of the period covered by each annual and quarterly report that the company is required to file under the Exchange Act. The company's certifying officers already are required to evaluate the effectiveness of the company's disclosure controls and procedures on a quarterly basis.⁸⁰ We noted that a quarterly evaluation requirement with respect to internal controls would create symmetry between our requirements for periodic evaluations of both the company's disclosure controls and procedures and its internal controls and procedures for financial reporting, and give effect to the language in the Section 302 certification requirements regarding quarterly internal control evaluations.

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

2. Comments on the Proposal

We received responses from 25 commenters on the proposed amendments. Of the 25 commenters, four supported the proposal to require quarterly evaluations of internal controls and procedures for financial reporting.⁸¹ One commenter specifically concurred with our objective of creating symmetry between the requirements to conduct periodic evaluations of both the company's disclosure controls and procedures and its internal controls and procedures for financial reporting.⁸²

Twenty-one commenters opposed quarterly evaluations of internal controls.⁸³ Many of these believed that quarterly evaluations would impose substantial additional costs on companies without producing any incremental benefit to investors. One individual stated that the proper evaluation of a company's system of internal controls is a weighty and time-consuming process.⁸⁴ Twelve of the commenters opposed to quarterly evaluations indicated that quarterly evaluations of all aspects of internal controls and procedures would be extremely burdensome, expensive and difficult to perform under the time constraints of quarterly reporting, particularly as the accelerated filing deadlines for quarterly reports take effect.⁸⁵ Several other commenters argued that we should not go beyond the requirements of Section 404 of the Sarbanes-Oxley Act with respect to the frequency of internal control reporting without an adequate basis for doing so.⁸⁶ These commenters remarked that such a decision would be better made after we have had sufficient experience with the Section 302 certification requirements adopted in August of 2002.

Several commenters suggested alternatives to quarterly evaluations. Five commenters stated that it would be more appropriate and desirable if companies were required to make quarterly disclosure only of material changes to their internal control that occurred subsequent to management's most recent annual internal control evaluation.⁸⁷ Two other commenters similarly recommended that the quarterly evaluation be less rigorous than the annual evaluation.⁸⁸ One commenter stated that we should instead adopt an approach that requires less effort and assurance for purposes of quarterly reports, such as permitting companies to test compliance with controls relating to major applications on a rotating basis throughout the year.⁸⁹ This commenter further stated that the objective of the quarterly evaluation should be to identify changes in controls during the quarter and evaluate whether they would change the certifying officers' conclusions about disclosure controls and internal controls as stated in the most recent annual report. The other commenter, although opposed to any quarterly evaluation requirement, believed that if we did require it, the quarterly evaluation should be viewed as an update of the annual evaluation, just as the quarterly report on Form 10-Q is an update of the annual report on Form 10-K.⁹⁰ One commenter stated that if we require some form of quarterly certification, it should be limited to negative assurance that nothing has come to the

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

certifying officers' attention since the prior year's evaluation to suggest that the controls are no longer effective.⁹¹

3. Final Rules

After consideration of the comments received, we have decided not to require quarterly evaluations of internal control over financial reporting that are as extensive as the annual evaluation. We recognize that some controls operate continuously while others operate only at certain times, such as the end of the fiscal year. We believe that each company should be afforded the flexibility to design its system of internal control over financial reporting to fit its particular circumstances. The management of each company should perform evaluations of the design and operation of the company's entire system of internal control over financial reporting over a period of time that is adequate for it to determine whether, as of the end of the company's fiscal year, the design and operation of the company's internal control over financial reporting are effective.

Accordingly, we are adopting amendments that require a company's management, with the participation of the principal executive and financial officers, to evaluate any change in the company's internal control over financial reporting that occurred during a fiscal quarter that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting. We also have adopted a modification to the Section 302 certification requirement and our disclosure requirements to adopt this approach, as discussed below.

The management of a foreign private issuer that has Exchange Act reporting obligations must also, like its domestic counterparts, report any material changes to the issuer's internal control over financial reporting. However, because foreign private issuers are not required to file quarterly reports under Section 13(a) or 15(d) of the Exchange Act, the final rules clarify that a foreign private issuer's management need only disclose in the issuer's annual report the material changes to its internal control over financial reporting that have occurred in the period covered by the annual report.⁹²

D. Differences between Internal Control over Financial Reporting and Disclosure Controls and Procedures

Many of the commenters on the Proposing Release indicated that they were confused as to the differences between a company's disclosure controls and procedures and a company's internal control over financial reporting. Exchange Act Rule 13a-15(d) defines "disclosure controls and procedures" to mean controls and procedures of a company that are designed to ensure that information required to be disclosed by the company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. The definition further states that disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that the information required to be disclosed by a company in the reports that it

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

While there is substantial overlap between a company's disclosure controls and procedures and its internal control over financial reporting, there are both some elements of disclosure controls and procedures that are not subsumed by internal control over financial reporting and some elements of internal control that are not subsumed by the definition of disclosure controls and procedures.

With respect to the latter point, clearly, the broad COSO description of internal control, which includes the efficiency and effectiveness of a company's operations and the company's compliance with laws and regulations (not restricted to the federal securities laws), would not be wholly subsumed within the definition of disclosure controls and procedures. A number of commenters suggested that the narrower concept of internal control, involving internal control over financial reporting, is a subset of a company's disclosure controls and procedures, given that the maintenance of reliable financial reporting is a prerequisite to a company's ability to submit or file complete disclosure in its Exchange Act reports on a timely basis. This suggestion focuses on the fact that the elements of internal control over financial reporting requiring a company to have a process designed 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 can be viewed as a subset of disclosure controls and procedures.

We agree that some components of internal control over financial reporting will be included in disclosure controls and procedures for all companies. In particular, disclosure controls and procedures will include those components of internal control over financial reporting that provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles. However, in designing their disclosure controls and procedures, companies can be expected to make judgments regarding the processes on which they will rely to meet applicable requirements. In doing so, some companies might design their disclosure controls and procedures so that certain components of internal control over financial reporting pertaining to the accurate recording of transactions and disposition of assets or to the safeguarding of assets are not included. For example, a company might have developed internal control over financial reporting that includes as a component of safeguarding of assets dual signature requirements or limitations on signature authority on checks. That company could nonetheless determine that this component is not part of disclosure controls and procedures. We therefore believe that while there is substantial overlap between internal control over financial reporting and disclosure controls and procedures, many companies will design their disclosure controls and procedures so that they do not include all components of internal control over financial reporting.

E. Evaluation of Disclosure Controls and Procedures

The rules in place starting in August 2002 requiring quarterly evaluations of disclosure controls and procedures and disclosure of the conclusions regarding effectiveness of disclosure controls and procedures have not been substantially changed since their adoption, including in the rules that we adopt today. These evaluation and disclosure requirements will continue to apply to disclosure controls and procedures, including the elements of internal control over financial reporting that are subsumed within disclosure controls and procedures.

With respect to evaluations of disclosure controls and procedures, companies must, under our rules and consistent with the Sarbanes-Oxley Act, evaluate the effectiveness of those controls and procedures on a quarterly basis. While the evaluation is of effectiveness overall, a company's management has the ability to make judgments (and it is responsible for its judgments) that evaluations, particularly quarterly evaluations, should focus on developments since the most recent evaluation, areas of weakness or continuing concern or other aspects of disclosure controls and procedures that merit attention. Finally, the nature of the quarterly evaluations of those components of internal control over financial reporting that are subsumed within disclosure controls and procedures should be informed by the purposes of disclosure controls and procedures.⁹³

The rules adopted in August 2002 required the management of an Exchange Act reporting foreign private issuer to evaluate and disclose conclusions regarding the effectiveness of the issuer's disclosure controls and procedures only in its annual report and not on a quarterly basis. The primary reason for this treatment is because foreign private issuers are not subject to mandated quarterly reporting requirements under the Exchange Act. The rules adopted today continue this treatment.⁹⁴

F. Periodic Disclosure about the Certifying Officers' Evaluation of the Company's Disclosure Controls and Procedures and Disclosure about Changes to its Internal Control over Financial Reporting

1. Existing Disclosure Requirements

The rules that we adopted in August 2002 to implement the certification requirements of Section 302 of the Sarbanes-Oxley Act included new Item 307 of Regulations S-B and S-K. Paragraph (a) of Item 307 requires companies, in their quarterly and annual reports, to disclose the conclusions of the company's principal executive and financial officers (or persons performing similar functions) about the effectiveness of the company's disclosure controls and procedures as of a date within 90 days of the filing date of the quarterly or annual report. This disclosure enables the certifying officers to satisfy the representation made in their certifications that they have "presented in the quarterly or annual report their conclusions about the effectiveness of the disclosure controls and procedures based on their evaluation."

Paragraph (b) of Item 307 requires the company to disclose in each quarterly and annual report whether or not there were significant changes in the company's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses. This disclosure enables the certifying officers to satisfy the representation made in their certifications that they have "indicated in the quarterly or annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses."

2. Proposed Amendments to the Disclosure Requirements

In the Proposing Release, we proposed several revisions to the existing disclosure requirements regarding: (1) the certifying officers' evaluation of the company's disclosure controls and procedures; and (2) changes to the company's internal control over financial reporting. We also proposed to require quarterly disclosure regarding the conclusions of the certifying officers about the effectiveness of the company's internal control over financial reporting.

Moreover, we proposed to require evaluations of both types of controls as of the end of the period covered by the quarterly or annual report, rather than "as of a date within 90 days of the filing date" of the quarterly or annual report, as currently required with respect to disclosure controls. With respect to the disclosure about changes to the company's internal control over financial reporting, we proposed to require a company to disclose "any significant changes made during the period covered by the quarterly or annual report" rather than "whether or not there were significant changes in the company's internal control over financial reporting that could significantly affect these controls subsequent to the date of their evaluation."

The commenters were mixed in their reaction to these proposed changes. A couple of the commenters remarking on the point at which a company must undertake an evaluation of its controls "strongly agreed" with the proposed change to require evaluations as of the end of the period. Several other commenters preferred the existing "90 days within the filing date" evaluation point, noting that it provides more flexibility than the fixed point. Some of these commenters expressed concern that it would be hard to conduct evaluations on the last day of the period. One of the commenters suggested that the proposed requirement that a company disclose changes to its internal control over financial reporting that occurred at any time during a fiscal quarter was inconsistent with the proposed requirement that management evaluate such changes "as of the end of each fiscal quarter."⁹⁵ An additional commenter asserted that it was critical that we offer companies some guidance as to the types of changes that constitute "significant changes."⁹⁶ Finally, a few commenters noted that while we had proposed to

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

delete the words "or other factors" from Exchange Act Rules 13a-14(b)(6) and 15d-14(b)(6) regarding disclosure of "significant changes in internal controls or in other factors that could significantly affect internal controls..." we had not likewise proposed to delete those words from the actual certification language.

3. Final Disclosure Requirements

After consideration of the comments, we are adopting the proposals with several modifications. We are adopting as proposed the change of the evaluation date for disclosure controls to "as of the end of the period" covered by the quarterly or annual report. We are not specifying the point at which management must evaluate changes to the company's internal control over financial reporting. Given that the final rules do not require a company to state the conclusions of the certifying officers regarding the effectiveness of the company's internal control over financial reporting as of a particular date on a quarterly basis as proposed, as the company must with respect to disclosure controls and procedures, it is unnecessary to specify a date for the quarterly evaluation of changes in internal control over financial reporting. We believe that this change is consistent with the new accelerated reporting deadlines.⁹⁷

We are amending the proposal that would have required companies to disclose any significant changes in its internal controls. Under the final rules, a company must disclose any change in its internal control over financial reporting that occurred during the fiscal quarter covered by the quarterly report, or the last fiscal quarter in the case of an annual report, that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.⁹⁸ Furthermore, we have deleted the phrase "or in other factors" from Exchange Act Rules 13a-14 and 15d-15 and the form of certification. Although the final rules do not explicitly require the company to disclose the reasons for any change that occurred during a fiscal quarter, or to otherwise elaborate about the change, a company will have to determine, on a facts and circumstances basis, whether the reasons for the change, or other information about the circumstances surrounding the change, constitute material information necessary to make the disclosure about the change not misleading.⁹⁹

While an evaluation of the effectiveness of disclosure controls and procedures must be undertaken on a quarterly basis, we expect that for purposes of disclosure by domestic companies, the traditional relationship between disclosure in annual reports on Form 10-K and intervening quarterly reports on Form 10-Q will continue. Disclosure in an annual report that continues to be accurate need not be repeated. Rather, disclosure in quarterly reports may make appropriate reference to disclosures in the most recent annual report (and, where appropriate, intervening quarterly reports) and disclose subsequent developments required to be disclosed in the quarterly report.

We note that, as required by the Sarbanes-Oxley Act, the quarterly certification regarding disclosure that the certifying officers must make to the

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

company's auditors and audit committee provides:¹⁰⁰

The company's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the company's auditors and the audit committee of the company's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the company's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal control over financial reporting.

We expect that if a certifying officer becomes aware of a significant deficiency, material weakness or fraud requiring disclosure outside of the formal evaluation process or after the management's most recent evaluation of internal control over financial reporting, he or she will disclose it to the company's auditors and audit committee.

4. Conclusions Regarding Effectiveness of Disclosure Controls and Procedures

In disclosures required under current Item 307 of Regulations S-K and S-B, Item 15 of Form 20-F and General Instruction B(6) to Form 40-F, some companies have indicated that disclosure controls and procedures are designed only to provide "reasonable assurance" that the controls and procedures will meet their objectives. In reviewing those disclosures, the Commission staff generally has not objected to that type of disclosure. The staff has, however, requested companies including that type of disclosure to set forth, if true, the conclusions of the principal executive and principal financial officer that the disclosure controls and procedures are, in fact, effective at the "reasonable assurance" level. Other companies have included disclosure that there is "no assurance" that the disclosure controls and procedures will operate effectively under all circumstances. In these instances, the staff has requested companies to clarify that the disclosure controls and procedures are designed to provide reasonable assurance of achieving their objectives and to set forth, if true, the conclusions of the principal executive and principal financial officers that the controls and procedures are, in fact, effective at the "reasonable assurance" level.

The concept of reasonable assurance is built into the definition of internal control over financial reporting that we are adopting. This conforms to the standard contained in the internal accounting control provisions of Section 13(b)(2) of the Exchange Act¹⁰¹ and current auditing literature.¹⁰² If management decides to include a discussion of reasonable assurance in the internal control report, the discussion must be presented in a manner that neither makes the disclosure in the report confusing nor renders

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

management's assessment concerning the effectiveness of the company's internal control over financial reporting unclear.

G. Attestation to Management's Internal Control Report by the Company's Registered Public Accounting Firm

In the Proposing Release, we proposed to amend Rules 210.1-02 and 210.2-02 of Regulation S-X to make conforming revisions to Regulation S-X to reflect the registered public accounting firm attestation requirements mandated by Section 404(b) of the Sarbanes-Oxley Act. Under the proposals, we set forth a definition for the new term "attestation report on management's evaluation of internal control over financial reporting" and certain requirements for the accountant's attestation report. We are adopting the proposals substantially as proposed. However, the final rules define the expanded term "attestation report on management's evaluation of internal control over financial reporting." Several commenters suggested that we use this more specific term, noting that auditors currently perform attestation engagements on a broad variety of subjects. Amended Rule 2-02 requires every registered public accounting firm that issues an audit report on the company's financial statements that are included in its annual report required by Section 13(a) or 15(d) of the Exchange Act containing an assessment by management of the effectiveness of the registrant's internal control over financial reporting must attest to, and report on, such assessment.

At the time of the enactment of the Sarbanes-Oxley Act, the applicable standard for attestation by auditors of internal control over financial reporting was set forth in Statements on Standards for Attestation Engagements No. 10 ("SSAE No. 10"). That standard was used by auditors providing attestations on a voluntary basis to companies, as well as by auditors whose financial institution clients are required to obtain attestations under Federal Deposit Insurance Corporation Improvement Act of 1991, ¹⁰³ as discussed below. Under the Sarbanes-Oxley Act, the PCAOB has become the body that sets auditing and attestation standards generally for registered public accounting firms to use in the preparation and issuance of audit reports on the financial statements of issuers, and under Section 404(b) of the Sarbanes-Oxley Act, the PCAOB is required to set standards for the registered public accounting firms' attestations to, and reports on, management's assessment regarding its internal control over financial reporting.

On April 16, 2003, the PCAOB designated Statements on Standards for Attestation Engagements as existed on April 16 as the standard for attestations of management's assessment of the effectiveness of internal control over financial reporting pending further PCAOB standard-setting in the area (and subject to our approval of the PCAOB's actions), and on April 25, we approved the PCAOB's action. SSAE No. 10 is thus the standard applicable on a transition basis for attestations required under Section 404 of the Act and the rules we are adopting today, again pending further PCAOB standard-setting (and our approval). We expect that the PCAOB will assess the appropriateness of those standards and modify them as needed, and any

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

future standards adopted by the PCAOB will apply to registered public accounting firms in connection with the preparation and issuance of attestation reports on management's assessment of the effectiveness of internal control over financial reporting.

H. Types of Companies Affected

Section 404 of the Sarbanes-Oxley Act states that the Commission must prescribe rules that require each annual report required by Section 13(a) or 15(d) of the Exchange Act to contain an internal control report. The Act exempts registered investment companies from this requirement. ¹⁰⁴

1. Foreign Private Issuers

Section 404 of the Sarbanes-Oxley Act makes no distinction between domestic and foreign issuers and, by its terms, clearly applies to foreign private issuers. These amendments, therefore, apply the management report on internal control over financial reporting requirement to foreign private issuers that file reports under Section 13(a) or 15(d) of the Exchange Act. We have, however, adopted a later compliance date for foreign private issuers than for accelerated filers.

2. Asset-Backed Issuers

In the Proposing Release, we proposed to exclude issuers of asset-backed securities from the proposed rules implementing Section 404 of the Act. We noted that because of the unique nature of asset-backed issuers, such issuers are subject to substantially different reporting requirements. Most significantly, asset-backed issuers are generally not required to file the types of financial statements that other companies must file. Also, such entities typically are passive pools of assets, without a board of directors or persons acting in a similar capacity. We did not receive any comments on the proposed exclusion of asset-backed issuers from the internal control reporting requirements, and we are excluding asset-backed issuers from the new disclosure requirements as proposed.

3. Small Business Issuers

Our proposed rules implementing Section 404 of the Act did not distinguish between large and small issuers. Similarly, Section 404 of the Act directs that the management report on internal control over financial reporting apply to any company filing periodic reports under Section 13(a) or 15(d) of the Exchange Act. Accordingly, these amendments apply to all issuers that file Exchange Act periodic reports, except registered investment companies, regardless of their size. However, we are sensitive that many small business issuers may experience difficulty in evaluating their internal control over financial reporting because these issuers may not have as formal or well-structured a system of internal control over financial reporting as larger companies. Accordingly, we are providing an extended compliance period for

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

small business issuers and other companies that are not accelerated filers.¹⁰⁵ In addition, our approach of not mandating specific criteria to be used by management to evaluate a company's internal control over financial reporting should provide small issuers some flexibility in meeting these disclosure requirements.

4. Bank and Thrift Holding Companies

In the Proposing Release, we stated that we were coordinating with the Federal Deposit Insurance Corporation (the "FDIC") and the other federal banking regulators to eliminate, to the extent possible, any unnecessary duplication between our proposed internal control report and the FDIC's internal control report requirements. Under regulations adopted by the FDIC implementing Section 36 of the Federal Deposit Insurance Act,¹⁰⁶ a federally insured depository institution with total assets of \$500 million or more ("institution"), is required, among other things, to prepare an annual management report that contains:

- A statement of management's responsibility for preparing the institution's annual financial statements, for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and for complying with designated laws and regulations relating to safety and soundness;¹⁰⁷ and
- Management's assessment of the effectiveness of the institution's internal control structure and procedures for financial reporting as of the end of the fiscal year and the institution's compliance with the designated safety and soundness laws and regulations during the fiscal year.¹⁰⁸

The FDIC's regulations additionally require the institution's independent accountant to examine, and attest to, management's assertions concerning the effectiveness of the institution's internal control structure and procedures for financial reporting.¹⁰⁹ The institution's management report and the accountant's attestation report must be filed with the FDIC, the institution's primary federal regulator (if other than the FDIC), and any appropriate state depository institution supervisor and must be available for public inspection.¹¹⁰

Although bank and thrift holding companies are not required under the FDIC's regulations to prepare these internal control reports, many of these holding companies do so under a provision of Part 363 of the FDIC's regulations¹¹¹ that permits an insured depository institution that is the subsidiary of a holding company to satisfy its internal control report requirements with an internal control report of the consolidated holding company's management if:

- Services and functions comparable to those required of the subsidiary

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

by Part 363 are provided at the holding company level,¹¹² and

- The subsidiary has, as of the beginning of its fiscal year, (i) total assets of less than \$5 billion or (ii) total assets of \$5 billion or more and a composite rating of 1 or 2 under the Uniform Financial Institutions Rating System.¹¹³

Section 404 of the Sarbanes-Oxley Act does not contain an exemption for insured depository institutions that are both subject to the FDIC's internal control report requirements and required to file Exchange Act reports. In fact, it makes no distinction whatsoever between institutions subject to the FDIC's requirements and other types of Exchange Act filers. Accordingly, regardless of whether an insured depository institution is subject to the FDIC's requirements, insured depository institutions or holding companies that are required to file periodic reports under Section 13(a) or 15(d) of the Exchange Act are subject to the internal control reporting requirements that we are adopting today.

Although our final rules are similar to the FDIC's internal control report requirements, the rules differ in a few significant respects. Most notably, our final rules do not require a statement of compliance with designated laws and regulations relating to safety and soundness. Conversely, the following provisions in our rules are not included in the FDIC's regulations:

- The requirement that the report include a statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting;¹¹⁴
- The requirement that management disclose any material weakness that it has identified in the company's internal control over financial reporting (and related stipulation that management is not permitted to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses);
- The requirement that the company state that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the company's internal control over financial reporting; and
- The requirement that the company must provide the registered public accounting firm's attestation report on management's assessment of internal control over financial reporting in the company's annual report filed under the Exchange Act.¹¹⁵

Several commenters generally supported our goal to eliminate or reduce duplicative reporting requirements. Some of these commenters asserted that we should recognize the substantial protections to depositors and investors provided by the federal laws that govern depository institutions and their

holding companies. They suggested that our final rules should state that compliance with the FDIC's internal control report requirements satisfies the internal control report requirements that we are adopting under Section 404. A number of these commenters also thought that if we did not exempt insured depository institutions already filing internal control reports under the FDIC's requirements, we should provide an exemption in our rules mirroring the FDIC's exemption that excludes insured depository institutions or their holding companies with less than \$500 million in assets from the internal control report requirements.

After consultation with the staffs of the FDIC, the Federal Reserve Board, the Office of Thrift Supervision and the Office of the Comptroller of Currency, we have determined that insured depository institutions that are subject to Part 363 of the FDIC's regulations (as well as holding companies permitted to file an internal control report on behalf of their insured depository institution subsidiaries in satisfaction of these regulations) and also subject to our new rules implementing Section 404 of the Sarbanes-Oxley Act¹¹⁶ should be afforded considerable flexibility in determining how best to satisfy both sets of requirements. Therefore, they can choose either of the following two options:

- They can prepare two separate management reports to satisfy the FDIC's and our new requirements; or
- They can prepare a single management report that satisfies both the FDIC's requirements and our new requirements.

If an insured depository institution or its holding company chooses to prepare a single report to satisfy both sets of requirements, the report of management on the institution's or holding company's internal control over financial reporting (as defined in Exchange Act Rule 13a-15(f) or 15d-15(f)) will have to contain the following:¹¹⁷

- A statement of management's responsibility for preparing the registrant's annual financial statements, for establishing and maintaining adequate internal control over financial reporting for the registrant, and for the institution's compliance with laws and regulations relating to safety and soundness designated by the FDIC and the appropriate federal banking agencies;
- A statement identifying the framework used by management to evaluate the effectiveness of the registrant's internal control over financial reporting as required by Exchange Act Rule 13a-15 or 15d-15;
- Management's assessment of the effectiveness of the registrant's internal control over financial reporting as of the end of the registrant's most recent fiscal year, including a statement as to whether or not management has concluded that the registrant's internal control over financial reporting is effective, and of the institution's compliance with

the designated safety and soundness laws and regulations during the fiscal year. This discussion must include disclosure of any material weakness in the registrant's internal control over financial reporting identified by management;¹¹⁸ and

- A statement that the registered public accounting firm that audited the financial statements included in the registrant's annual report has issued an attestation report on management's assessment of the registrant's internal control over financial reporting.

Additionally, the institution or holding company will have to provide the registered public accounting firm's attestation report on management's assessment in its annual report filed under the Exchange Act.¹¹⁹ For purposes of the report of management and the attestation report, financial reporting must encompass both financial statements prepared in accordance with GAAP and those prepared for regulatory reporting purposes.

I. Registered Investment Companies

Section 404 of the Sarbanes-Oxley Act does not apply to registered investment companies, and we are not extending any of the requirements that would implement section 404 to registered investment companies.¹²⁰ Several commenters objected to the proposed requirement that the Section 302 certification include a statement of the officers' responsibility for internal controls.¹²¹ These commenters argued that this requirement would contradict Section 405 of the Sarbanes-Oxley Act and represent a "back-door" application of Section 404, from which registered investment companies are exempt.¹²² We disagree. The certification requirements implement Section 302 of the Sarbanes-Oxley Act, from which registered investment companies are not exempt.¹²³ We are not subjecting registered investment companies to the requirements implementing Section 404 of the Sarbanes-Oxley Act, including the annual and quarterly evaluation requirements with respect to internal control over financial reporting and the requirements for an annual report by management on internal control over financial reporting and an attestation report on management's assessment.

We are adopting the following technical changes to our rules and forms implementing Section 302 of the Sarbanes-Oxley Act for registered investment companies in order to conform to the changes that we are adopting for operating companies.¹²⁴

- Paragraph (d) of Investment Company Act Rule 30a-3. The amendments use the same term "internal control over financial reporting" that we are using in the rules for operating companies and include the same definition of "internal control over financial reporting" that we are adopting in Exchange Act Rules 13a-15(f) and 15d-15(f).
- Paragraph (a) of Investment Company Act Rule 30a-3. The

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

amendments require every registered management investment company, other than a small business investment company, to maintain internal control over financial reporting. These amendments parallel those that we are adopting for operating companies in Exchange Act Rules 13a-15(a) and 15d-15(a).

- Introductory text and sub-paragraph (b) of paragraph 4 of the certification in Item 10(a)(2) of Form N-CSR. The amendments require the signing officers to state that they are responsible for establishing and maintaining internal control over financial reporting, and that they have designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under their supervision, 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.
- Paragraph (4)(d) of the certification of Item 10(a)(2), and Item 9(b) of Form N-CSR. The amendments require disclosure of any change in the investment company's internal control over financial reporting that occurred during the most recent fiscal half-year that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.
- Paragraph (5) of the certification of Item 10(a)(2) of Form N-CSR. The amendments require the signing officers to state that they have disclosed to the investment company's auditors and the audit committee all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the investment company's ability to record, process, summarize, and report financial information.

We are not, however, adopting proposed amendments that would have required the evaluation by an investment company's management of the effectiveness of its disclosure controls and procedures to be as of the end of the period covered by each report on Form N-CSR, rather than within 90 days prior to the filing date of the report, as our certification rules currently require.¹²⁵ Commenters noted that this would require investment company complexes that have funds with staggered fiscal year ends to perform evaluations of their disclosure controls and procedures as many as twelve times per year. They argued that requiring such frequent evaluations would be extremely costly, inefficient, and operationally disruptive, and would not provide any benefits to shareholders.¹²⁶ We agree that the costs of requiring investment company complexes to perform evaluations of their disclosure controls and procedures twelve times per year would outweigh the benefits to investors. The certification rules we are adopting will require an investment company complex to perform at most four such evaluations per year.¹²⁷

Transition Period for Registered Investment Companies

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

Registered investment companies must comply with the rule and form amendments applicable to them on and after August 14, 2003, except as follows. Registered investment companies must comply with the amendments to Exchange Act Rules 13a-15(a) and 15d-15(a) and Investment Company Act Rule 30a-3(a) that require them to maintain internal control over financial reporting with respect to fiscal years ending on or after June 15, 2004. In addition, registered investment companies must comply with the portion of the introductory language in paragraph 4 of the certification in Item 10(a)(2) of Form N-CSR that refers to the certifying officers' responsibility for establishing and maintaining internal control over financial reporting, as well as paragraph 4(b) of the certification, beginning with the first annual report filed on Form N-CSR for a fiscal year ending on or after June 15, 2004.

J. Transition Period

We received a number of comments urging us to adopt an extended transition period for compliance with the new disclosure requirements.¹²⁸ We have decided to delay the compliance date of the requirement to provide a management report assessing the effectiveness of internal control over financial reporting and an auditor's attestation to, and report on, that assessment beyond that in the Proposing Release so that companies and their auditors will have time to prepare and satisfy the new requirements. These compliance dates do not apply to registered investment companies, which are not required to provide the management report assessing the effectiveness of internal control over financial reporting and the related auditor's attestation.¹²⁹ A company that is an "accelerated filer," as defined in Exchange Act Rule 12b-2, as of the end of its first fiscal year ending on or after June 15, 2004, must begin to comply with the management report on internal control over financial reporting disclosure requirements promulgated under Section 404 of the Sarbanes-Oxley Act in its annual report for that fiscal year. We recognize that non-accelerated filers, including smaller companies and foreign private issuers, may have greater difficulty in preparing the management report on internal control over financial reporting. Therefore, these types of companies must begin to comply with the disclosure requirements in annual reports for their first fiscal year ending on or after April 15, 2005. A company must begin to comply with the quarterly evaluation of changes to internal control over financial reporting requirements for its first periodic report due after the first annual report that must include management's report on internal control over financial reporting. We believe that the transition period is appropriate in light of both the substantial time and resources needed to properly implement the rules¹³⁰ and the corresponding benefit to investors that will result. In addition, the transition period will provide additional time for the PCAOB to consider relevant factors in determining and implementing any new attestation standard as it finds appropriate, subject to our approval.

Consistent with this extended compliance period for management's internal control report and the related attestation, and for the subsequent evaluation of changes in internal control over financial reporting, the following provisions

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

of the rules adopted today are subject to the extended compliance period:

- The provisions of Items 308(a) and (b) of Regulations S-K and S-B and the comparable provisions of Forms 20-F and 40-F requiring management's internal control report and the related attestation;
- The amendments to Rules 13a-15(a) and 15d-15(a) under the Exchange Act relating to maintenance of internal control over financial reporting; and
- The provisions of Rules 13a-15(c) and (d) and 15d-15(c) and (d) under the Exchange Act requiring evaluations of internal control over financial reporting and changes thereto.

The extended compliance period does not in any way affect the provisions of our other rules and regulations regarding internal controls that are in effect, including, without limitation, Rule 13b-2 under the Exchange Act.

Other rules relating to evaluation and disclosure adopted today are effective on August 14, 2003. These other rules include amendments to Items 308(c) of Regulations S-K and S-B and the comparable provisions of Forms 20-F and 40-F requiring disclosure regarding certain changes in internal control over financial reporting. These amendments modify existing requirements regarding disclosure of changes in internal control over financial reporting, are related to statements made in the Section 302 certifications of principal executive and financial officers, and provide clarifications that are beneficial and whose implementation need not be delayed. These other rules that are effective on August 14, 2003, also include amendments relating to disclosure controls and procedures.

III. DISCUSSION OF AMENDMENTS RELATED TO CERTIFICATIONS

A. Proposed Rules

We proposed to amend our rules and forms to require companies to file the certifications required by Section 302 of the Sarbanes-Oxley Act as an exhibit to the periodic reports to which they relate. Specifically, we proposed to amend the exhibit requirements of Forms 20-F and

40-F and Item 601 of Regulations S-B and S-K to add the Section 302 certifications to the list of required exhibits. In addition, we proposed to amend Exchange Act Rules 13a-14 and 15d-14 to require that Section 906 certifications accompany the periodic reports to which they relate, and to amend Forms 20-F and 40-F and Item 601 of Regulations S-B and S-K to add Section 906 certifications to the list of required exhibits. We also proposed to amend Investment Company Act Rule 30a-2 to require that Section 906 certifications accompany the periodic reports on Form N-CSR to which they relate and Item 10 of Form N-CSR to add the Section 906 certifications as a required exhibit.

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

We received eight comment letters in response to the proposals.¹³¹ The primary topic addressed by the commenters was whether Section 906 of the Sarbanes-Oxley Act applied to annual reports filed on Form 11-K. Most of the commenters believed that issuers required to file annual reports on Form 11-K should be exempt from the requirement to furnish a Section 906 certification as an exhibit.¹³² Two commenters noted that the language of Section 906 that requires certification of the chief executive officer and chief financial officer (or equivalent thereof) is inconsistent with the actual administration of employee benefit plans because such plans do not have individuals acting as chief executive officer and chief executive officer.¹³³ Those commenters noted that employee benefit plans are typically administered through one or more committees that are appointed as the plan's named fiduciaries to administer the plan and oversee investments.¹³⁴ In addition, some commenters believed that we should provide an exemption for Form 11-K because employee benefit plans are already subject to extensive regulation under the Employee Retirement Income Security Act of 1974 ("ERISA"),¹³⁵ which includes a requirement for the plan administrator to certify, under penalties of perjury and other criminal and administrative penalties, the accuracy of the plan's disclosures under ERISA.¹³⁶

Commenters also addressed other topics related to Section 906. One commenter requested that the Commission allow Section 906 certifications to remain confidential.¹³⁷ That commenter expressed concern that a plaintiff could use a Section 906 certification to create a basis for liability that did not otherwise exist.¹³⁸ One commenter objected to the proposal to deem Section 906 certifications as "furnished," rather than as "filed."¹³⁹ After considering all of the comments, we are adopting the proposals substantially as proposed.

On April 11, 2003, U.S. Senator Joseph Biden introduced a statement into the Congressional Record that discusses Section 906.¹⁴⁰ The statement asserts that Section 906 "is intended to apply to any financial statement filed by a publicly-traded company, upon which the investing public will rely to gauge the financial health of the company," which includes financial statements included in current reports on Forms 6-K and 8-K and annual reports on Form 11-K.¹⁴¹ The language added to Title 18 by Section 906 refers to "periodic reports containing financial statements," and our proposals to require companies to furnish Section 906 certifications as exhibits applied to periodic (annual, semi-annual and quarterly) reports but did not address current reports on Forms 6-K and 8-K.¹⁴² One commenter addressed the statement in the Congressional Record, indicating that the suggested requirements would create substantial practical burdens for companies to provide Section 906 certifications in current reports filed on Forms 6-K or 8-K.¹⁴³ We are also concerned that extending Section 906 certifications to Forms 6-K or 8-K could potentially chill the disclosure of information by companies. As noted above, four commenters argued that Section 906 should not apply to Form 11-K.¹⁴⁴ In light of these developments, we are

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

considering, in consultation with the Department of Justice, the application of Section 906 to current reports on Forms 6-K and 8-K and annual reports on Form 11-K and the possibility of taking additional action.

B. Final Rules

We are amending the exhibit requirements of Forms 20-F and 40-F and Item 601 of Regulations S-B and S-K to add the Section 302 certifications to the list of required exhibits.¹⁴⁵ In the final rules, the specific form and content of the required certifications is set forth in the applicable exhibit filing requirement.¹⁴⁶ To coordinate the rules requiring an evaluation of "disclosure controls and procedures" and "internal control over financial reporting," we are moving the definition of the term "disclosure controls and procedures" from Exchange Act Rules 13a-14(c) and 15d-14(c) and Investment Company Act Rule 30a-2(c) to new Exchange Act Rules 13a-15(c) and 15d-15(c) and Investment Company Act Rule 30a-3(c), respectively.

We are amending Exchange Act Rules 13a-14 and 15d-14 and Investment Company Act Rule 30a-2 to require the Section 906 certifications to accompany periodic reports containing financial statements as exhibits. We also are amending the exhibit requirements in Forms 20-F, 40-F and Item 601 of Regulations S-B and S-K to add the Section 906 certifications to the list of required exhibits to be included in reports filed with the Commission. In addition, we are amending Item 10 of Form N-CSR to add the Section 906 certifications as a required exhibit. Because the Section 906 certification requirement applies to periodic reports containing financial statements that are filed by an issuer pursuant to Section 13(a) or 15(d) of the Exchange Act, the exhibit requirement will only apply to reports on Form N-CSR filed under these sections and not to reports on Form N-CSR that are filed under the Investment Company Act only.¹⁴⁷ A failure to furnish the Section 906 certifications would cause the periodic report to which they relate to be incomplete, thereby violating Section 13(a) of the Exchange Act.¹⁴⁸ In addition, referencing the Section 906 certifications in Exchange Act Rules 13a-14 and 15d-14 and Investment Company Act Rule 30a-2 subjects these certifications to the signature requirements of Rule 302 of Regulation S-T.¹⁴⁹

Section 906 requires that the certifications "accompany" the periodic report to which they relate. This is in contrast to Section 302, which requires the certifications to be included "in" the periodic report. In recognition of this difference, we are permitting companies to "furnish," rather than "file," the Section 906 certifications with the Commission.¹⁵⁰ Thus, the certifications would not be subject to liability under Section 18 of the Exchange Act.¹⁵¹ Moreover, the certifications would not be subject to automatic incorporation by reference into a company's Securities Act registration statements, which are subject to liability under Section 11 of the Securities Act,¹⁵² unless the issuer takes steps to include the certifications in a registration statement.

Although Section 906 does not explicitly require the certifications to be made

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

public, we believe that it is appropriate to require certifications that "accompany" a publicly filed periodic report to be provided publicly in this manner. We believe that Congress intended for Section 906 certifications to be publicly provided. Civil liability already exists under our signature requirements and the Section 302 certifications. In addition, any Section 906 certification submitted to the Commission as correspondence is subject to the Freedom of Information Act.¹⁵³ Finally, the requirement to furnish Section 906 certifications as exhibits serves a number of important functions. First, the exhibit requirement enhances compliance by allowing the Commission, the Department of Justice and the public to monitor the certifications effectively. Second, by subjecting the Section 906 certifications to the signature requirements of Regulation S-T, companies are required to retain a manually signed signature page or other authenticating document for a five-year period. This requirement helps to preserve evidential matter in the event of prosecution.

There are important distinctions to be made between Sections 302 and 906 of the Sarbanes-Oxley Act. Unlike the Section 302 certifications, the Section 906 certifications are required only in periodic reports that contain financial statements. Therefore, amendments to periodic reports that do not contain financial statements would not require a new Section 906 certification, but would require a new Section 302 certification to be filed with the amendment.¹⁵⁴ In addition, unlike the Section 302 certifications, the Section 906 certifications may take the form of a single statement signed by a company's chief executive and financial officers.¹⁵⁵

C. Effect on Interim Guidance Regarding Filing Procedures

We provided interim guidance regarding voluntary filing procedures for Section 906 certifications.¹⁵⁶ That guidance encouraged issuers to submit their Section 906 certifications as exhibits to the periodic reports to which they relate.¹⁵⁷ For issuers that are not investment companies, that interim voluntary guidance shall remain in effect until the rules become effective. In the event that the EDGAR system is not updated by the effective date, companies should submit the required certifications as Exhibit 99.¹⁵⁸ For registered investment companies, the interim guidance shall remain in effect until the rules become effective.¹⁵⁹

D. Form of Section 302 Certifications

We proposed several amendments to the form of certifications to be provided pursuant to Section 302 of the Sarbanes-Oxley Act. In particular, we proposed the following:

- The addition of a statement that principal executive and financial officers are responsible for designing internal controls and procedures for financial reporting or having such controls and procedures designed under their supervision;

- The clarification that disclosure controls and procedures may be designed under the supervision of principal executive and financial officers; and
- The revision of the statement as to the effectiveness of disclosure controls and procedures and internal controls and procedures for financial reporting would be as of the end of the period.

We have adopted the proposals referred to above substantially as proposed. In addition, we have made the following changes:

- We have incorporated the term "internal control over financial reporting" into the certification;
- We have amended the provision of the certification relating to changes in internal control over financial reporting, consistent with the final rules discussed above regarding evaluation and disclosure, so that it refers to changes that have materially affected or are reasonably likely to materially affect internal control over financial reporting;
- We have clarified that the statement as effectiveness of disclosure controls and procedures be as of the end of the period, but that the date of the evaluation is not specified; and
- We have made minor changes in the organization of the certification.

E. Transition Period

The final rules regarding filing of certifications under Sections 302 and 906, for companies other than registered investment companies, will be effective on August 14, 2003. The compliance dates applicable to registered investment companies are described in Section II. I., above.

We believe that changes in the form of Section 302 certification described above are beneficial to both registrants and investors because they clarify the provisions of the certification. With one exception, discussed below, the changes are also not related to our new requirements regarding management's internal control report. With that one exception, appropriateness of the modified certification is thus not affected by the extended compliance period we are providing in connection with management's internal control report and the related attestation. Our rules adopted today also therefore provide that the form of Section 302 certification will be modified, with that one exception, in accordance with these rules effective on August 14, 2003.

We are applying the extended compliance period to the portion of the introductory language in paragraph 4 of the Section 302 certification that refers to the certifying officers' responsibility for establishing and maintaining internal control over financial reporting for the company, as well as

paragraph 4(b), which must be provided in the first annual report required to contain management's internal control report and thereafter. As noted above, this extended compliance period does not in any way affect the provisions of our other rules and regulations regarding internal controls that are in effect.

IV. PAPERWORK REDUCTION ACT

A. Background

Certain provisions of our final amendments contain "collection of information" requirements within the meaning of the Paperwork Reduction Act of 1995 ("PRA").¹⁶⁰ We published a notice requesting comment on the collection of information requirements in the proposing release for the rule amendments, and we submitted these requirements to the Office of Management and Budget ("OMB") for review in accordance with the PRA.¹⁶¹ The titles for the collection of information are:

- (1) "Form 10-Q" (OMB Control No. 3235-0070);
- (2) "Form 10-QSB" (OMB Control No. 3235-0416);
- (3) "Form 10-K" (OMB Control No. 3235-0063);
- (4) "Form 10-KSB" (OMB Control No. 3235-0420);
- (5) "Form 20-F" (OMB Control No. 3235-0288);
- (6) "Form 40-F" (OMB Control No. 3235-0381);
- (7) "Regulation S-X" (OMB Control No. 3235-0009);
- (8) "Regulation S-K" (OMB Control No. 3235-0071);
- (9) "Regulation S-B" (OMB Control No. 3235-0417); and
- (10) "Form N-CSR" (OMB Control No. 3235-0570).

The forms are periodic reports adopted under the Exchange Act and the Investment Company Act. The regulations set forth the disclosure requirements for periodic reports, registration statements and proxy and information statements filed by companies to ensure that investors are informed. The hours and costs associated with preparing, filing and sending these forms constitute reporting and cost burdens imposed by each collection of information. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid OMB control number. Compliance with the requirements is mandatory. Under our rules for the retention of manual signatures,¹⁶² companies must retain, for a period of five years, an original signature page

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

or other document authenticating, acknowledging or otherwise adopting the certifying officers' signatures that appear in their electronically filed periodic reports. Responses to the information collections are not kept confidential.

B. Summary of the Final Rules

The final rules require the annual report of every company that files periodic reports under Section 13(a) or 15(d) of the Exchange Act, other than reports by registered investment companies, to contain a report of management that includes:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company;
- A statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting;
- Management's assessment of the effectiveness of the company's internal control over financial reporting, as of the end of the most recent fiscal year; and
- A statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's evaluation of the company's internal control over financial reporting.

We are adding these requirements pursuant to the legislative mandate in Section 404 of the Sarbanes-Oxley Act. Under our final rules, a company also will be required to evaluate and disclose any change in its internal control over financial reporting that occurred during the fiscal quarter that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

We are also adopting amendments to require companies to file the certifications mandated by Sections 302 and 906 of the Sarbanes-Oxley Act as exhibits to their annual, semi-annual and quarterly reports. These amendments will enhance the ability of investors, the Commission staff, the Department of Justice and other interested parties to easily and efficiently access the certifications through our Electronic Data Gathering, Analysis and Retrieval ("EDGAR") system and facilitate better monitoring of a company's compliance with the certification requirements.

C. Summary of Comment Letters and Revisions to Proposals

We requested comment on the PRA analysis contained in the proposing releases addressing Section 404 and Sections 302 and 906 of the Sarbanes-Oxley Act.¹⁶³ We received no comments on our PRA estimates for the

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

certification requirements. With respect to our PRA estimates for the rules implementing Section 404 of the Sarbanes-Oxley Act, eight commenters thought that our PRA estimates significantly understated the actual time and costs that companies would have to expend evaluating and reporting on their internal control over financial reporting.¹⁶⁴ However, few of these commenters provided actual alternative cost estimates, and none provided estimates that could be applied generally to all types and sizes of companies. One commenter believed that, based on its experience, we understated the burden estimate by at least a factor of 100.¹⁶⁵ In response to these commenters, and based on follow-up conversations with several of the commenters who expressed a view on our burden and cost estimates, we have revised our estimates as discussed more fully in Section IV.D below.

We have made a substantive modification to the proposed rules in response to the cost concerns expressed by commenters. Specifically, the final rules require companies to undertake a quarterly evaluation only of any change occurring during the fiscal quarter that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting. This change should substantially mitigate some of the costs and burdens associated with the proposed requirements.

We have made additional substantive changes to the proposed rule as well. First, the final rules require management to evaluate the company's internal control over financial reporting using a suitable framework, such as the COSO Framework. Second, the final rules expand the list of information that must be included in the management report and specify that management cannot conclude that a company's internal control over financial reporting is effective if there are one or more material weaknesses in such control. Under the final rules, management must identify the framework used to evaluate the company's internal control over financial reporting and disclose any material weaknesses in the company's internal control over financial reporting discovered through the evaluation. We do not believe that these changes significantly alter the burdens imposed on companies resulting from the required assessment of internal control over financial reporting.

D. Revisions to PRA Reporting and Cost Burden Estimates

As discussed above, in consideration of commenters' remarks, we are revising our PRA burden and cost estimates for the rules pertaining to Section 404 that we originally submitted to the OMB in connection with the proposed rules.

We derived our new burden hour estimates for the annual report forms by estimating the total amount of time that it will take a company's management to conduct the annual evaluation of its internal control over financial reporting and to prepare the required management report.¹⁶⁶ Our annual burden estimate is based on several assumptions. First, we assumed that the annual number of responses for each form would be consistent with the number of filings that we received in fiscal year 2002.¹⁶⁷ Second, we

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

assumed that there is a direct correlation between the extent of the burden and the size of the reporting company, with the burden increasing commensurate with the size of the company. We believe that there will be a marked disparity of burdens and costs resulting from the new internal control requirements between the largest and smallest reporting companies. Our estimates reflect an average burden for all sizes of companies. Third, we assumed that the first-year burden would be greater than that for subsequent years, as a portion of the costs will reflect one-time expenditures associated with complying with the rule, such as compiling documentation, implementing new processes, and training staff. We also adjusted the second and third year estimates to account for the fact that management should become more efficient at conducting its internal control assessment and preparing the disclosure after the first year as the process becomes more routine.¹⁶⁸ Under these assumptions, we estimate that the average incremental burden for an annual filing will be 383 hours per company and the portion of that burden that is reflected as the cost associated with outside professionals is approximately \$34,300 per company. For large corporations, we expect that this burden will be substantially higher. Indeed, we received estimates in the thousands of hours for some large and complex companies. Conversely, we expect small companies to find their burden to be less than this average. We also believe that many companies will experience costs well in excess of this average in the first year of compliance with the final rules. We believe that costs will decrease in subsequent years. This burden will also vary among companies based on the complexity of their organization and the nature of their current internal control procedures. We therefore calculated our estimates by averaging the estimated burdens over a three-year period.

We derived our burden estimates for the quarterly report forms by estimating the total amount of time that it will take a company's management to conduct the quarterly evaluation of material changes to the company's internal control over financial reporting and for the company to prepare the required disclosure about such changes. We believe that these quarterly evaluations will impose little additional burden, as much of the structure to conduct these evaluations will be established in connection with the annual evaluations. We estimate that the quarterly reporting will impose an additional burden of five hours per company in connection with each quarterly report. Accordingly, we did not revise our original burden hour estimates for the quarterly report forms.

We estimate the total annual incremental burden (for annual and quarterly reports) associated with the new internal control evaluation and disclosure requirements for all companies to be approximately 3,792,888 hours of company personnel time and a cost of \$481,013,550 for the services of outside professionals.¹⁶⁹

Table 1 below presents these burdens and costs for each form affected by the final rules implementing Section 404 of Sarbanes-Oxley. We calculated the burden by multiplying the estimated number of affected responses by the estimated average number of hours that management will spend conducting its assessment of the company's internal control over financial reporting and

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

preparing the related disclosure. For Exchange Act annual reports, we estimate that 75% of the burden of preparation is carried by the company internally and that 25% of the burden of preparation is carried by outside professionals retained by the company at an average cost of \$300 per hour.¹⁷⁰ The portion of the burden carried by outside professionals is reflected as a cost, while the portion of the burden carried by the company internally is reflected in hours. There is no change to the estimated burden of the collections of information entitled "Regulation S-K," "Regulation S-B" and "Regulation S-X" because the burdens that these regulations impose are reflected in our revised estimates for the forms.

Table 1: Incremental Paperwork Burden for the rules implementing Section 404

We do not believe that the amendments with respect to the Section 302 certifications result in a need to alter the burden estimates that we previously submitted to OMB because they merely relocate the certifications from the text of quarterly and annual reports filed or submitted under Section 13(a) or 15(d) of the Exchange Act to the "Exhibits" section of the reports. We are, however, revising the burden estimates for quarterly and annual reports and for Form N-CSR based on the amendment with respect to the Section 906 certification.¹⁷¹ The PRA estimates for these amendments do not reflect a cost because we believe that the entire burden will be borne by company personnel. With respect to semi-annual reports on Form N-CSR, because the financial statements of registered management investment companies are not as complex as those of operating companies, we estimate that the amendments relating to the Section 906 certifications would result in an increase of one burden hour per portfolio.¹⁷² We estimate that there are approximately 3,700 registered management investment companies that are required to file reports on Form N-CSR, containing 9,850 portfolios. The following table illustrates the incremental PRA estimates for the new Section 906 certification requirements:

Table 2: Incremental Paperwork Burden for Certification Requirements

Form	Annual Responses	Hours/Form	Total Hours Added
20-F	1,194	2	2,388
40-F	134	2	268
10-K	8,484	2	16,968
10-KSB	3,820	2	7,640
10-Q	23,743	2	47,486
10-QSB	11,299	2	22,598

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

N-CSR	7,400	2.66 ¹⁷³	19,700
Total			117,048

V. COST-BENEFIT ANALYSIS

The amendments implementing Section 404 of the Sarbanes-Oxley Act are congressionally mandated. We recognize that implementation of the Sarbanes-Oxley Act will likely result in costs and benefits to the economy. We are sensitive to the costs and benefits imposed by our rules, and we have considered costs and benefits of our amendments.

A. Benefits

One of the main goals of the Sarbanes-Oxley Act is to enhance the quality of reporting and increase investor confidence in the financial markets. Recent market events have evidenced a need to provide investors with a clearer understanding of the processes that surround the preparation and presentation of financial information. These amendments are intended to accomplish the Act's goals by improving public company disclosure to investors about the extent of management's responsibility for the company's financial statements and internal control over financial reporting and the means by which management discharges its responsibility. The establishment and maintenance of internal control over financial reporting has always been an important responsibility of management. An effective system of internal control over financial reporting is necessary to produce reliable financial statements and other financial information used by investors. By requiring a report of management stating management's responsibility for the company's financial statements and internal control over financial reporting and management's assessment regarding the effectiveness of such control, investors will be able to better evaluate management's performance of its stewardship responsibilities and the reliability of a company's financial statements and other unaudited financial information.

The required annual evaluation of internal control over financial reporting will encourage companies to devote adequate resources and attention to the maintenance of such control. Additionally, the required evaluation should help to identify potential weaknesses and deficiencies in advance of a system breakdown, thereby facilitating the continuous, orderly and timely flow of information within the company and, ultimately, to investors and the marketplace. Improved disclosure may help companies detect fraudulent financial reporting earlier and perhaps thereby deter financial fraud or minimize its adverse effects. All of these benefits will increase market efficiency by improving investor confidence in the reliability of a company's financial disclosure and system of internal control over financial reporting. These benefits are not readily quantifiable. Commenters overwhelmingly supported the benefits of the amendments.

The amendments related to Section 302 of the Sarbanes-Oxley Act relocate the certifications required by Exchange Act Rules 13a-14 and 15d-14 from

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

the text of quarterly and annual reports filed or submitted under Section 13 (a) or 15(d) of the Exchange Act to the "Exhibits" section of these reports. The amendments related to Section 906 of the Sarbanes-Oxley Act require that the certifications required by Section 1350 of Title 18 of the United States Code, added by Section 906 of the Act, accompany the periodic reports to which they relate as exhibits. These changes will enhance the ability of investors and the Commission staff to verify that the certifications have, in fact, been submitted with the Exchange Act reports to which they relate and to review the contents of the certifications to ensure compliance with the applicable requirements. In addition, the changes will enable the Department of Justice, which has responsibility for enforcing Section 906, to review effectively the form and content of the certifications required by that section.

B. Costs

The final rules related to Section 404 of the Sarbanes-Oxley Act require companies, other than registered investment companies, to include in their annual reports a report of management on the company's internal control over financial reporting. The management report on internal control over financial reporting must include: a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting; a statement identifying the framework used to evaluate the effectiveness of the company's internal control over financial reporting; management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year; and a statement that the registered public accounting firm that audited the company's financial statements included in the annual report has issued an attestation report on management's evaluation of the company's internal control over financial reporting. The final rules will increase costs for all reporting companies. These costs are mitigated somewhat because companies have an existing obligation to maintain an adequate system of internal accounting control under the FCPA. Moreover, one commenter noted that some companies already voluntarily include management reports on their internal controls in their annual reports. The preparation of the management report on internal control over financial reporting will likely involve multiple parties, including senior management, internal auditors, in-house counsel, outside counsel and audit committee members.

Many commenters believed that our proposal to require quarterly evaluations of a company's internal control over financial reporting would significantly increase the costs of preparing periodic reports. Several commenters also were concerned that the proposals would result in increased audit fees. We have limited data on which to base cost estimates of the final rules.

Using our PRA burden estimates, we estimate the aggregate annual costs of implementing Section 404(a) of the Sarbanes-Oxley Act to be around \$1.24 billion (or \$91,000 per company).¹⁷⁴ We recognize the magnitude of the cost burdens and we are making several accommodations to address commenters' concerns and to ease compliance, including:

- Requiring quarterly disclosure only of any change that has materially affected, or is reasonably likely to materially affect, a company's internal control over financial reporting; and
- An extended transition period for the new internal control reporting requirements.

We originally proposed to require a company to include an internal control report in its annual report for fiscal years ending on or after September 15, 2003. Under the final rules, a company that is an "accelerated filer" under the definition in Exchange Act Rule 12b-2 must begin to comply with the internal control report requirement in its annual report for its first fiscal year ending on or after June 15, 2004. All other companies must begin to comply with the requirement in their annual reports for their first fiscal year ending on or after April 15, 2005.

A longer transition period will help to alleviate the immediate impact of any costs and burdens imposed on companies. A longer transition period may even help to reduce costs as companies will have additional time to develop best practices, long-term processes and efficiencies in preparing management reports. Also, a longer transition period will expand the period of availability of outside professionals that some companies may wish to retain as they prepare to comply with the new requirements.

The PRA burden estimate, however, excludes several costs attributable to Section 404. The estimate does not include the costs associated with the auditor's attestation report, which many commenters have suggested might be substantial. It also excludes estimates of likely "indirect" costs of the final rules. For instance, the final rules increase the cost of being a public company; therefore the final rules may discourage some companies from seeking capital from the public markets. Moreover, the final rules may also discourage non-U.S. firms from seeking capital in the United States.

The incremental costs of the amendments related to Section 302 of the Sarbanes-Oxley Act are minimal. Since companies must already include the certifications required by Exchange Act Rules 13a-14 and 15d-14 in their quarterly and annual reports, there should be no incremental cost to relocating the certifications from the text of the reports to the "Exhibits" section of these reports. Requiring the Section 906 certifications to be included as an exhibit to the periodic reports to which they relate will lead to some additional costs for companies that currently are submitting the certifications to the Commission in some other manner. While these costs are difficult to quantify, we estimate that the annual paperwork burden of the amendments will be approximately \$23.4 million.¹⁷⁵

One commenter has expressed concern that companies may assume greater legal risk by making their Section 906 certifications publicly available.¹⁷⁶ To the extent that companies may assume greater legal risk by including the Section 906 certifications as part of their periodic reports filed pursuant to

the Exchange Act where these reports are incorporated by reference into Securities Act registration statements, we address this risk by requiring companies to "furnish," rather than "file," the certifications with the Commission for purposes of Section 18 of the Exchange Act or incorporation by reference into other filings. Thus, the amendments should mitigate this potential indirect cost of compliance. We believe that it is appropriate to require the certifications that accompany a periodic report to be publicly available. We believe that Congress intended for Section 906 certifications to be publicly available. Civil liability already exists by virtue of the pre-existing signature requirements and Section 302 certifications. In addition, any Section 906 certification submitted to the Commission as correspondence is subject to the Freedom of Information Act.¹⁷⁷

VI. EFFECT ON EFFICIENCY, COMPETITION AND CAPITAL FORMATION

Section 23(a)(2) of the Exchange Act¹⁷⁸ requires us to consider the anti-competitive effects of any rules that we adopt under the Exchange Act. In addition, Section 23(a)(2) prohibits us from adopting any rule that would impose a burden on competition not necessary or appropriate in furtherance of the purposes of the Exchange Act. The amendments related to Section 404 of the Sarbanes-Oxley Act represent the implementation of a congressional mandate. The final rules require management reports that improve investors' understanding of management's responsibility for the preparation of reliable financial information and maintaining adequate internal control over financial reporting. We anticipate that these requirements will enhance the proper functioning of the capital markets by increasing the quality and accountability of financial reporting and restoring investor confidence.

Section 2(b) of the Securities Act,¹⁷⁹ Section 3(f) of the Exchange Act¹⁸⁰ and Section 2(c) of the Investment Company Act¹⁸¹ require us, when engaging in rulemaking to consider or determine whether an action is necessary or appropriate in the public interest, and consider whether the action will promote efficiency, competition, and capital formation. The amendments related to Section 404 are designed to enhance the quality and accountability of the financial reporting process and may help increase investor confidence, which implies increased efficiency and competitiveness of the U.S. capital markets. Increased market efficiency and investor confidence also may encourage more efficient capital formation. We requested comments on the effect of these amendments on efficiency, competition and capital formation analyses in the proposing release addressing Section 404. We received no comments in response to these requests.

The amendments related to Section 302 of the Sarbanes-Oxley Act would relocate the certifications required by Exchange Act Rules 13a-14 and 15d-14 from the text of quarterly and annual reports filed or submitted under Section 13(a) or 15(d) of the Exchange Act to the "Exhibits" section of these reports. This relocation will enhance the ability of investors and the Commission staff to verify that the certifications have, in fact, been submitted with the Exchange Act reports to which they relate and to review the contents of the

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

certifications to ensure compliance with the applicable requirements. The amendments related to Section 906 of the Sarbanes-Oxley Act also will streamline compliance with Section 1350 of Title 18 of the United States Code, added by Section 906 of the Act, and will enable investors, the Commission staff and the Department of Justice, which has responsibility for enforcing Section 1350, to verify submission and efficiently review the form and content of the certifications required by that provision.

We do not believe that the amendments related to certifications will impose any burden on competition, nor are we aware of any impact on capital formation that would result from the amendments. Depending on how an issuer's principal executive and principal financial officers presently satisfy the Section 906 certification requirements, issuers may incur some additional costs in submitting these certifications as an exhibit to their periodic reports. While these costs are difficult to quantify, we believe that they would be nominal. We requested comment on whether the amendments would affect competition, efficiency and capital formation. We received no comments in response to this request.

VII. FINAL REGULATORY FLEXIBILITY ANALYSIS

This Final Regulatory Flexibility Analysis ("FRFA") has been prepared in accordance with the Regulatory Flexibility Act.¹⁸² This FRFA relates to new rules and amendments that require Exchange Act companies, other than registered investment companies, to include in their annual reports a report of management on the company's internal control over financial reporting. The management report on internal control over financial reporting must include: a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting; a statement identifying the framework used to evaluate the effectiveness of the company's internal control over financial reporting; management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year; and a statement that the registered public accounting firm that audited the company's financial statements included in the annual report has issued an attestation report on management's evaluation of the company's internal control over financial reporting. This FRFA also addresses new rules and amendments that require companies to file the certifications mandated by Sections 302 and 906 of the Sarbanes-Oxley Act as exhibits to their periodic reports. An Initial Regulatory Flexibility Analysis ("IRFA") was prepared in accordance with the Regulatory Flexibility Act in conjunction with each of the releases proposing these rules.¹⁸³ The proposing releases solicited comments on these analyses.

A. Need for the Amendments

We are adopting these disclosure requirements to comply with the mandate of, and to fulfill the purposes underlying the provisions of, the Sarbanes-Oxley Act of 2002. The new evaluation and disclosure requirements regarding a company's internal control over financial reporting are intended to enhance

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

the quality of reporting and increase investor confidence in the fairness and integrity of the securities markets by making it clear that a company's management is responsible for maintaining and annually assessing such controls. The amendments related to Sections 302 and 906 of the Sarbanes-Oxley Act will enhance the ability of investors and the Commission staff to verify that the certifications have, in fact, been submitted with the Exchange Act reports to which they relate and to review the contents of the certifications to ensure compliance with the applicable requirements. The amendments also will streamline compliance with Section 1350 of Title 18 of the United States Code and will enable investors, the Commission staff and the Department of Justice, which has responsibility for enforcing Section 1350, to verify a company's submission of the Section 906 certification and efficiently review the form and content of the certifications.

B. Significant Issues Raised by Public Comment

In the Proposing Releases, we requested comment on any aspect of the IRFA, including the number of small entities that would be affected by the proposals, and both quantitative and qualitative nature of the impact. Several commenters expressed concern that small business issuers, including small entities, would be particularly disadvantaged by our proposal to require quarterly evaluations of internal control over financial reporting. We received no commentary on the impact on small entities of the new certification requirements.

C. Small Entities Subject to the Amendments

The new disclosure items affect issuers that are small entities. Exchange Act Rule 0-10(a)¹⁸⁴ defines an issuer, other than an investment company, to be a "small business" or "small organization" if it had total assets of \$5 million or less on the last day of its most recent fiscal year. We estimate that there are approximately 2,500 issuers, other than investment companies, that may be considered small entities. For purposes of the Regulatory Flexibility Act, an investment company is a "small entity" if it, together with other investment companies in the same group of related investment companies, has net assets of \$50 million or less as of the end of its most recent fiscal year.¹⁸⁵ We estimate that there are approximately 190 registered management investment companies that, together with other investment companies in the same group of related investment companies, have net assets of \$50 million or less as of the end of the most recent fiscal year.¹⁸⁶

The new disclosure items with respect to management's report on internal control over financial reporting and the registered public accounting firm's attestation report apply to any small entity, other than a registered investment company, that is subject to Exchange Act reporting requirements. The new certification requirements apply to any small entity that is subject to Exchange Act reporting requirements.

D. Reporting, Recordkeeping and other Compliance Requirements

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

The amendments require a company's management to disclose information regarding the company's internal control over financial reporting, including management's assessment of the effectiveness of the company's internal control over financial reporting. All small entities that are subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act, other than registered investment companies, are subject to these evaluation and disclosure requirements. Because reporting companies already file the forms being amended, no additional professional skills beyond those currently possessed by these filers necessarily are required to prepare the new disclosure, although some companies may choose to engage outside professionals to assist them in complying with the new requirements. We expect that these new disclosure items will increase compliance costs incurred by small entities. We have calculated for purposes of the Paperwork Reduction Act that each company would be subject to an added annual reporting burden of approximately 398 hours and the portion of that burden that is reflected as the cost associated with outside professionals is approximately \$35,286.¹⁸⁷ We believe, however, that the annual average burden and costs for small issuers are much lower.¹⁸⁸ For the new certification requirements, we estimate that a company, including a small entity, will be subject to an additional reporting burden of eight hours per year.¹⁸⁹ These burden estimates reflect only the burden and cost of the required collection of information.

E. Agency Action to Minimize Effect on Small Entities

The Regulatory Flexibility Act directs us to consider alternatives that would accomplish our stated objectives, while minimizing any significant adverse impact on small entities. In connection with the amendments, we considered the following alternatives:

- Establishing different compliance or reporting requirements or timetables that take into account the resources available to small entities;
- Clarifying, consolidating or simplifying compliance and reporting requirements under the rules for small entities;
- Using performance rather than design standards; and
- Exempting small entities from all or part of the requirements.

Several of these alternatives were considered but rejected, while other alternatives were taken into account in the final rules. We believe the final rules fulfill the intent of the Sarbanes-Oxley Act of enhancing the quality of reporting and increasing investor confidence in the fairness and integrity of the securities markets.

Sections 302, 404 and 906 of the Sarbanes-Oxley Act make no distinction

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

based on a company's size. We think that improvements in the financial reporting process for all companies are important for promoting investor confidence in our markets. For example, a 1999 report commissioned by the organizations that sponsored the Treadway Commission found that the incidence of financial fraud was greater in small companies.¹⁹⁰ However, we are sensitive to the costs and burdens that small entities will face. The final rules require only a quarterly evaluation of material changes to a company's internal control over financial reporting, unlike the proposed rules that would have required management to evaluate the effectiveness of a company's internal control over financial reporting on a quarterly basis. In response to comments, including comments submitted by the Small Business Administration, we have decided not to adopt this proposal.

We believe that a blanket exemption for small entities from coverage of the requirements is not appropriate and would be inconsistent with the policies underlying the Sarbanes-Oxley Act. However, we have provided an extended transition period for companies that do not meet the definition in Exchange Act Rule 12b-2¹⁹¹ of an "accelerated filer" for the rules implementing Section 404 of the Sarbanes-Oxley Act. Under the adopted rules, non-accelerated filers, including small business issuers, need not prepare the management report on internal control over financial reporting until they file their annual reports for fiscal years ending on or after April 15, 2005. This deferral provides non-accelerated filers more time to develop structured and formal systems of internal control over financial reporting.

We believe that the new disclosure and certification requirements are clear and straightforward. The amendments require only brief disclosure. An effective system of internal control over financial reporting has always been necessary to produce reliable financial statements and other financial information. Our amendments do not specify any particular controls that a company's internal control over financial reporting should include. Each company is afforded the flexibility to design its internal control over financial reporting according to its own set of circumstances. This flexibility should enable companies to keep costs of compliance as low as possible. Therefore, it does not seem necessary to develop separate requirements for small entities.

The final rules impose both design and performance standards regarding disclosure of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company and management's assessment of the effectiveness of such controls. The rules do, however, afford a company the flexibility to design its internal control over financial reporting to fit its particular circumstances. We believe that it would be inconsistent with the purposes of the Sarbanes-Oxley Act to specify different requirements for small entities.

VIII. STATUTORY AUTHORITY AND TEXT OF RULE AMENDMENTS

The amendments described in this release are being adopted under the authority set forth in Sections 5, 6, 7, 10, 17 and 19 of the Securities Act, as

amended, Sections 12, 13, 15, 23 and 36 of the Exchange Act, Sections 8, 30, 31 and 38 of the Investment Company Act, as amended and Sections 3 (a), 302, 404, 405 and 906 of the Sarbanes-Oxley Act.

List of Subjects

17 CFR Part 210

Accountants, Accounting, Reporting and recordkeeping requirements, Securities.

17 CFR Part 228

Reporting and recordkeeping requirements, Securities, Small businesses.

17 CFR Parts 229, 240 and 249

Reporting and recordkeeping requirements, Securities.

17 CFR Parts 270 and 274

Investment companies, Reporting and recordkeeping requirements, Securities.

TEXT OF AMENDMENTS

For the reasons set out in the preamble, the Commission amends title 17, chapter II, of the Code of Federal Regulations as follows:

PART 210 - FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, INVESTMENT COMPANY ACT OF 1940, INVESTMENT ADVISERS ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975

1. The authority citation for Part 210 is revised to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 78c, 78j-1, 78l, 78m, 78n, 78o(d), 78q, 78u-5, 78w(a), 78ll, 78mm, 79e(b), 79j(a), 79n, 79t(a), 80a-8, 80a-20, 80a-29, 80a-30, 80a-31, 80a-37 (a), 80b-3, 80b-11, 7202 and 7262, unless otherwise noted.

2. Section 210.1-02 is amended by:

- a. Removing the authority citation following §210.1-02;
- b. Redesignating paragraph (a) as paragraph (a)(1); and

c. Adding paragraph (a)(2).

The revisions read as follows:

§210.1-02 Definition of terms used in Regulation S-X (17 CFR part 210).

* * * * *

(a)(1) * * *

(2) Attestation report on management's assessment of internal control over financial reporting. The term attestation report on management's assessment of internal control over financial reporting means a report in which a registered public accounting firm expresses an opinion, or states that an opinion cannot be expressed, concerning management's assessment of the effectiveness of the registrant's internal control over financial reporting (as defined in §240.13a-15(f) or 240.15d-15(f) of this chapter) in accordance with standards on attestation engagements. When an overall opinion cannot be expressed, the registered public accounting firm must state why it is unable to express such an opinion.

* * * * *

3. Amend §210.2-02 by:

- a. Revising the section heading;
- b. Revising the headings of paragraphs (a), (b), (c) and (d); and
- c. Adding paragraph (f).

The addition and revisions read as follows.

§210.2-02 Accountants' reports and attestation reports on management's assessment of internal control over financial reporting.

- (a) Technical requirements for accountants' reports. * * *
- (b) Representations as to the audit included in accountants' reports. * * *
- (c) Opinions to be expressed in accountants' reports. * * *
- (d) Exceptions identified in accountants' reports. * * *

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

* * * * *

(f) Attestation report on management's assessment of internal control over financial reporting. Every registered public accounting firm that issues or prepares an accountant's report for a registrant, other than an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), that is included in an annual report required by section 13 (a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) containing an assessment by management of the effectiveness of the registrant's internal control over financial reporting must attest to, and report on, such assessment. The attestation report on management's assessment of internal control over financial reporting shall be dated, signed manually, identify the period covered by the report and clearly state the opinion of the accountant as to whether management's assessment of the effectiveness of the registrant's internal control over financial reporting is fairly stated in all material respects, or must include an opinion to the effect that an overall opinion cannot be expressed. If an overall opinion cannot be expressed, explain why. The attestation report on management's assessment of internal control over financial reporting may be separate from the accountant's report.

PART 228 - INTEGRATED DISCLOSURE SYSTEM FOR SMALL BUSINESS ISSUERS

4. The general authority citation for Part 228 is revised to read as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa (25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77jjj, 77nnn, 77sss, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll, 78mm, 80a-8, 80a-29, 80a-30, 80a-37, 80b-11, 7202, 7241, and 7262; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

5. Revise §228.307 to read as follows:

§228.307 (Item 307) Disclosure controls and procedures.

Disclose the conclusions of the small business issuer's principal executive and principal financial officers, or persons performing similar functions, regarding the effectiveness of the small business issuer's disclosure controls and procedures (as defined in §240.13a-15(e) or 240.15d-15(e) of this chapter) as of the end of the period covered by the report, based on the evaluation of these controls and procedures required by paragraph (b) of §240.13a-15 or 240.15d-15 of this chapter.

6. Add §228.308 to read as follows:

§228.308 (Item 308) Internal control over financial reporting.

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

(a) Management's annual report on internal control over financial reporting. Provide a report of management on the small business issuer's internal control over financial reporting (as defined in §240.13a-15(f) or 240.15d-15 (f) of this chapter) that contains:

- (1) A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the small business issuer;
- (2) A statement identifying the framework used by management to evaluate the effectiveness of the small business issuer's internal control over financial reporting as required by paragraph (c) of §240.13a-15 or 240.15d-15 of this chapter;
- (3) Management's assessment of the effectiveness of the small business issuer's internal control over financial reporting as of the end of the small business issuer's most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective. This discussion must include disclosure of any material weakness in the small business issuer's internal control over financial reporting identified by management. Management is not permitted to conclude that the small business issuer's internal control over financial reporting is effective if there are one or more material weaknesses in the small business issuer's internal control over financial reporting; and
- (4) A statement that the registered public accounting firm that audited the financial statements included in the annual report containing the disclosure required by this Item has issued an attestation report on management's assessment of the small business issuer's internal control over financial reporting.

(b) Attestation report of the registered public accounting firm. Provide the registered public accounting firm's attestation report on management's assessment of the small business issuer's internal control over financial reporting in the small business issuer's annual report containing the disclosure required by this Item.

(c) Changes in internal control over financial reporting. Disclose any change in the small business issuer's internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of §240.13a-15 or 240.15d-15 of this chapter that occurred during the small business issuer's last fiscal quarter (the small business issuer's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the small business issuer's internal control over financial reporting.

Instructions to Item 308

1. The small business issuer must maintain evidential matter, including documentation, to provide reasonable support for management's assessment

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

of the effectiveness of the small business issuer's internal control over financial reporting.

2. A small business issuer that is an Asset-Backed Issuer (as defined in §240.13a-14(g) and §240.15d-14(g) of this chapter) is not required to disclose the information required by this Item.

7. Amend §228.401 by removing the phrase "internal controls and procedures for financial reporting" in paragraph (e)(2)(iv) of Item 401 and adding, in its place, the phrase "internal control over financial reporting".

8. Amend §228.601 by:

- a. Removing the last sentence of paragraph (a)(1);
- b. Revising the Exhibit Table;
- c. Revising paragraph (b)(7) to read "No exhibit required.";
- d. Revising the heading in paragraph (b)(11) to read "Statement re: computation of per share earnings"; and
- e. Revising paragraphs (b)(27) through (b)(98).

The revisions read as follows.

§228.601 (Item 601) Exhibits.

* * * * *

EXHIBIT TABLE

(b) Description of exhibits. * * *

(27) through (30) [Reserved]

(31) Rule 13a-14(a)/15d-14(a) Certifications. The certifications required by Rule 13a-14(a) (17 CFR 240.13a-14(a)) or Rule 15d-14(a) (17 CFR 240.15d-14(a)) exactly as set forth below:

CERTIFICATIONS*

I, [identify the certifying individual], certify that:

- 1. I have reviewed this [specify report] of [identify small business issuer];
- 2. 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;

- 3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the small business issuer as of, and for, the periods presented in this report;
- 4. The small business issuer's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the small business issuer and have:

(a) 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 small business issuer, 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;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

(c) Evaluated the effectiveness of the small business issuer'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; and

(d) Disclosed in this report any change in the small business issuer's internal control over financial reporting that occurred during the small business issuer's most recent fiscal quarter (the small business issuer's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the small business issuer's internal control over financial reporting; and

- 5. The small business issuer's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the small business issuer's auditors and the audit committee of the small business issuer's board of directors (or persons

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the small business issuer's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the small business issuer's internal control over financial reporting.

Date:

[Signature]
[Title]

* Provide a separate certification for each principal executive officer and principal financial officer of the small business issuer. See Rules 13a-14(a) and 15d-14(a)

(32) Section 1350.

(i) The certifications required by Rule 13a-14(b) (17 CFR 240.13a-14(b)) or Rule 15d-14(b) (17 CFR 240.15d-14(b)) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350).

(ii) A certification furnished pursuant to this Item will not be deemed "filed" for purposes of section 18 of the Exchange Act (15 U.S.C. 78r), or otherwise subject to the liability of that section. Such certification will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that the small business issuer specifically incorporates it by reference.

(33) through (98) [Reserved]

* * * * *

PART 229 - STANDARD INSTRUCTIONS FOR FILING FORMS UNDER SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934 AND ENERGY POLICY AND CONSERVATION ACT OF 1975 - REGULATION S-K

9. The general authority citation for Part 229 is revised to read as follows:

Authority: 15 U.S.C. 77e, 77f, 77g, 77h, 77j, 77k, 77s, 77z-2, 77z-3, 77aa (25), 77aa(26), 77ddd, 77eee, 77ggg, 77hhh, 77iii, 77jjj, 77nnn, 77sss, 78c,

78i, 78j, 78l, 78m, 78n, 78o, 78u-5, 78w, 78ll, 78mm, 79e, 79j, 79n, 79t, 80a-8, 80a-9, 80a-20, 80a-29, 80a-30, 80a-31(c), 80a-37, 80a-38(a), 80a-39, 80b-11, 7202, 7241, and 7262; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

10. By revising §229.307 to read as follows:

§229.307 (Item 307) Disclosure controls and procedures.

Disclose the conclusions of the registrant's principal executive and principal financial officers, or persons performing similar functions, regarding the effectiveness of the registrant's disclosure controls and procedures (as defined in §240.13a-15(e) or 240.15d-15(e) of this chapter) as of the end of the period covered by the report, based on the evaluation of these controls and procedures required by paragraph (b) of §240.13a-15 or 240.15d-15 of this chapter.

11. By adding §229.308 to read as follows:

§229.308 (Item 308) Internal control over financial reporting.

(a) Management's annual report on internal control over financial reporting. Provide a report of management on the registrant's internal control over financial reporting (as defined in §240.13a-15(f) or 240.15d-15(f) of this chapter) that contains:

- (1) A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the registrant;
- (2) A statement identifying the framework used by management to evaluate the effectiveness of the registrant's internal control over financial reporting as required by paragraph (c) of §240.13a-15 or 240.15d-15 of this chapter;
- (3) Management's assessment of the effectiveness of the registrant's internal control over financial reporting as of the end of the registrant's most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective. This discussion must include disclosure of any material weakness in the registrant's internal control over financial reporting identified by management. Management is not permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting; and
- (4) A statement that the registered public accounting firm that audited the financial statements included in the annual report containing the disclosure required by this Item has issued an attestation report on management's

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

assessment of the registrant's internal control over financial reporting.

(b) Attestation report of the registered public accounting firm. Provide the registered public accounting firm's attestation report on management's assessment of the registrant's internal control over financial reporting in the registrant's annual report containing the disclosure required by this Item.

(c) Changes in internal control over financial reporting. Disclose any change in the registrant's internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of §240.13a-15 or 240.15d-15 of this chapter that occurred during the registrant's last fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.

Instructions to Item 308

1. The registrant must maintain evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of the registrant's internal control over financial reporting.

2. A registrant that is an Asset-Backed Issuer (as defined in §240.13a-14(g) and §240.15d-14(g) of this chapter) is not required to disclose the information required by this Item.

12. By amending §229.401 by removing the phrase "internal controls and procedures for financial reporting" in paragraph (h)(2)(iv) of Item 401 and adding, in its place, the phrase "internal control over financial reporting".

13. By amending §229.601 by:

- a. Removing the second and third sentences of paragraph (a)(1);
- b. Revising the Exhibit Table which follows the Instructions to the Exhibit Table; and
- c. Revising paragraphs (b)(27) through (b)(98).

The revisions read as follows:

§229.601 (Item 601) Exhibits.

(a) Exhibits and index required. * * *

Instructions to the Exhibit Table

* * * * *

EXHIBIT TABLE

(b) Description of exhibits. * * *

(27) through (30) [Reserved]

(31) Rule 13a-14(a)/15d-14(a) Certifications. The certifications required by Rule 13a-14(a) (17 CFR 240.13a-14(a)) or Rule 15d-14(a) (17 CFR 240.15d-14(a)) exactly as set forth below:

CERTIFICATIONS*

I, [identify the certifying individual], certify that:

1. I have reviewed this [specify report] of [identify registrant];
2. 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;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

(a) 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;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

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; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date:

[Signature]
[Title]

* Provide a separate certification for each principal executive officer and principal financial officer of the registrant. See Rules 13a-14(a) and 15d-14(a).

(32) Section 1350 Certifications.

(i) The certifications required by Rule 13a-14(b) (17 CFR 240.13a-14(b)) or Rule 15d-14(b) (17 CFR 240.15d-14(b)) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350).

(ii) A certification furnished pursuant to this item will not be deemed "filed" for purposes of Section 18 of the Exchange Act (15 U.S.C. 78r), or otherwise subject to the liability of that section. Such certification will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that the registrant specifically incorporates it by reference.

(33) through (98) [Reserved]

* * * * *

PART 240 - GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

14. The general authority citation for Part 240 is revised to read as follows:

Authority: 15 U.S.C. 77c, 77d, 77g, 77j, 77s, 77z-2, 77z-3, 77eee, 77ggg, 77nnn, 77sss, 77ttt, 78c, 78d, 78e, 78f, 78g, 78i, 78j, 78j-1, 78k, 78k-1, 78l, 78m, 78n, 78o, 78p, 78q, 78s,

78u-5, 78w, 78x, 78ll, 78mm, 79q, 79t, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, 7202, 7241, 7262, and 7263; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

15. By revising §240.12b-15 to read as follows:

§240.12b-15 Amendments.

All amendments must be filed under cover of the form amended, marked with the letter "A" to designate the document as an amendment, e.g., "10-K/A," and in compliance with pertinent requirements applicable to statements and reports. Amendments filed pursuant to this section must set forth the complete text of each item as amended. Amendments must be numbered sequentially and be filed separately for each statement or report amended. Amendments to a statement may be filed either before or after registration becomes effective. Amendments must be signed on behalf of the registrant by a duly authorized representative of the registrant. An amendment to any report required to include the certifications as specified in §240.13a-14(a) or §240.15d-14(a) must include new certifications by each principal executive and principal financial officer of the registrant, and an amendment to any report required to be accompanied by the certifications as specified in §240.13a-14(b) or §240.15d-14(b) must be accompanied by new certifications by each principal executive and principal financial officer of the registrant. The requirements of the form being amended will govern the number of copies to be filed in connection with a paper format amendment. Electronic filers satisfy the provisions dictating the number of copies by filing one copy of the amendment in electronic format. See §232.309 of this chapter (Rule 309 of Regulation S-T).

16. By amending §240.13a-14 by:

a. Revising paragraphs (a) and (b);

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

- b. Removing paragraph (c);
- c. Redesignating paragraphs (d), (e) and (f) as paragraphs (c), (d) and (e);
- d. Revising newly redesignated paragraph (c), the introductory text of newly redesignated paragraph (d) and newly redesignated paragraph (e); and
- e. Adding and reserving new paragraph (f).

The revisions read as follows:

§240.13a-14 Certification of disclosure in annual and quarterly reports.

(a) Each report, including transition reports, filed on Form 10-Q, Form 10-QSB, Form 10-K, Form 10-KSB, Form 20-F or Form 40-F (§§249.308a, 249.308b, 249.310, 249.310b, 249.220f or 249.240f of this chapter) under section 13(a) of the Act (15 U.S.C. 78m(a)), other than a report filed by an Asset-Backed Issuer (as defined in paragraph (g) of this section), must include certifications in the form specified in the applicable exhibit filing requirements of such report and such certifications must be filed as an exhibit to such report. Each principal executive and principal financial officer of the issuer, or persons performing similar functions, at the time of filing of the report must sign a certification.

(b) Each periodic report containing financial statements filed by an issuer pursuant to section 13(a) of the Act (15 U.S.C. 78m(a)) must be accompanied by the certifications required by Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350) and such certifications must be furnished as an exhibit to such report as specified in the applicable exhibit requirements for such report. Each principal executive and principal financial officer of the issuer (or equivalent thereof) must sign a certification. This requirement may be satisfied by a single certification signed by an issuer's principal executive and principal financial officers.

(c) A person required to provide a certification specified in paragraph (a) or (b) of this section may not have the certification signed on his or her behalf pursuant to a power of attorney or other form of confirming authority.

(d) Each annual report filed by an Asset-Backed Issuer (as defined in paragraph (g) of this section) under section 13(a) of the Act (15 U.S.C. 78m(a)) must include a certification addressing the following items: * * *

(e) With respect to Asset-Backed Issuers, the certification required by paragraph (d) of this section must be signed by the trustee of the trust (if the trustee signs the annual report) or the senior officer in charge of securitization of the depositor (if the depositor signs the annual report). Alternatively, the senior officer in charge of the servicing function of the master servicer (or entity performing the equivalent functions) may sign the

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

certification.

(f) [Reserved]

* * * * *

17. Section 240.13a-15 is revised to read as follows:

§240.13a-15 Controls and procedures.

(a) Every issuer that has a class of securities registered pursuant to section 12http://www.law.uc.edu/CCL/34Act/sec12.html of the Act (15 U.S.C. 78l), other than an Asset-Backed Issuer (as defined in §240.13a-14(g)), a small business investment company registered on Form N-5 (§§ 239.24 and 274.5 of this chapter), or a unit investment trust as defined by section 4(2) of the Investment Company Act of 1940 (15 U.S.C. 80a-4(2)), must maintain disclosure controls and procedures (as defined in paragraph (e) of this section) and internal control over financial reporting (as defined in paragraph (f) of this section).

(b) Each such issuer's management must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, the effectiveness of the issuer's disclosure controls and procedures, as of the end of each fiscal quarter, except that management must perform this evaluation:

(1) In the case of a foreign private issuer (as defined in §240.3b-4) as of the end of each fiscal year; and

(2) In the case of an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), within the 90-day period prior to the filing date of each report requiring certification under §270.30a-2 of this chapter.

(c) The management of each such issuer, other than an investment company registered under section 8 of the Investment Company Act of 1940, must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, the effectiveness, as of the end of each fiscal year, of the issuer's internal control over financial reporting. The framework on which management's evaluation of the issuer's internal control over financial reporting is based must be a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment.

(d) The management of each such issuer, other than an investment company registered under section 8 of the Investment Company Act of 1940, must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, any

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

change in the issuer's internal control over financial reporting, that occurred during each of the issuer's fiscal quarters, or fiscal year in the case of a foreign private issuer, that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.

(e) For purposes of this section, the term disclosure controls and procedures means 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.

(f) The term internal control over financial reporting is defined 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:

- (1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
- (2) 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
- (3) 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.

18. By amending §240.15d-14 by:

- a. Revising paragraphs (a) and (b);
- b. Removing paragraph (c);
- c. Redesignating paragraphs (d), (e) and (f) as paragraphs (c), (d) and (e);
- d. Revising newly redesignated paragraph (c), the introductory text of newly

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

redesignated paragraph (d) and newly redesignated paragraph (e); and

e. Adding and reserving new paragraph (f).

The revisions read as follows.

§240.15d-14 Certification of disclosure in annual and quarterly reports.

(a) Each report, including transition reports, filed on Form 10-Q, Form 10-QSB, Form 10-K, Form 10-KSB, Form 20-F or Form 40-F (§§249.308a, 249.308b, 249.310, 249.310b, 249.220f or 249.240f of this chapter) under section 15(d) of the Act (15 U.S.C. 78o(d)), other than a report filed by an Asset-Backed Issuer (as defined in paragraph (g) of this section), must include certifications in the form specified in the applicable exhibit filing requirements of such report and such certifications must be filed as an exhibit to such report. Each principal executive and principal financial officer of the issuer, or persons performing similar functions, at the time of filing of the report must sign a certification.

(b) Each periodic report containing financial statements filed by an issuer pursuant to section 15(d) of the Act (15 U.S.C. 78o(d)) must be accompanied by the certifications required by Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350) and such certifications must be furnished as an exhibit to such report as specified in the applicable exhibit requirements for such report. Each principal executive and principal financial officer of the issuer (or equivalent thereof) must sign a certification. This requirement may be satisfied by a single certification signed by an issuer's principal executive and principal financial officers.

(c) A person required to provide a certification specified in paragraph (a) or (b) of this section may not have the certification signed on his or her behalf pursuant to a power of attorney or other form of confirming authority.

(d) Each annual report filed by an Asset-Backed Issuer (as defined in paragraph (g) of this section) under section 15(d) of the Act (15 U.S.C. 78o(d)), must include a certification addressing the following items: * * *

(e) With respect to Asset-Backed Issuers, the certification required by paragraph (d) of this section must be signed by the trustee of the trust (if the trustee signs the annual report) or the senior officer in charge of securitization of the depositor (if the depositor signs the annual report). Alternatively, the senior officer in charge of the servicing function of the master servicer (or entity performing the equivalent functions) may sign the certification.

(f) [Reserved]

* * * * *

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

19. Section 240.15d-15 is revised to read as follows:

§240.15d-15 Controls and procedures.

(a) Every issuer that files reports under section 15(d) of the Act (15 U.S.C. 78o(d)), other than an Asset-Backed Issuer (as defined in §240.15d-14(g) of this chapter), a small business investment company registered on Form N-5 (§§239.24 and 274.5 of this chapter), or a unit investment trust as defined in section 4(2) of the Investment Company Act of 1940 (15 U.S.C. 80a-4(2)), must maintain disclosure controls and procedures (as defined in paragraph (e) of this section) and internal control over financial reporting (as defined in paragraph (f) of this section).

(b) Each such issuer's management must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, the effectiveness of the issuer's disclosure controls and procedures, as of the end of each fiscal quarter, except that management must perform this evaluation:

(1) In the case of a foreign private issuer (as defined in §240.3b-4) as of the end of each fiscal year; and

(2) In the case of an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), within the 90-day period prior to the filing date of each report requiring certification under §270.30a-2 of this chapter.

(c) The management of each such issuer, other than an investment company registered under section 8 of the Investment Company Act of 1940, must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, the effectiveness, as of the end of each fiscal year, of the issuer's internal control over financial reporting. The framework on which management's evaluation of the issuer's internal control over financial reporting is based must be a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment.

(d) The management of each such issuer, other than an investment company registered under section 8 of the Investment Company Act of 1940, must evaluate, with the participation of the issuer's principal executive and principal financial officers, or persons performing similar functions, any change in the issuer's internal control over financial reporting, that occurred during each of the issuer's fiscal quarters, or fiscal year in the case of a foreign private issuer, that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.

(e) For purposes of this section, the term disclosure controls and procedures means controls and other procedures of an issuer that are designed to ensure

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

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.

(f) The term internal control over financial reporting is defined 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:

(1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;

(2) 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

(3) 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.

PART 249 - FORMS, SECURITIES EXCHANGE ACT OF 1934

20. The general authority citation for Part 249 and the subauthority citation for "Section 249.331" are revised to read as follows:

Authority: 15 U.S.C. 78a et seq., 7202, 7233, 7241, 7262, 7264, and 7265; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

Section 249.331 is also issued under 15 U.S.C. 78j-1, 7202, 7233, 7241, 7264, 7265; and 18 U.S.C. 1350.

* * * * *

21. By amending Form 10-Q (referenced in §249.308a) by:

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

- a. Removing the last sentence of General Instruction G;
- b. Revising Item 4 to "Part I - Financial Information;" and
- c. Removing the "Certifications" section after the "Signatures" section.

The revision reads as follows.

Note: The text of Form 10-Q does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM 10-Q

* * * * *

Part I - Financial Information

* * * * *

Item 4. Controls and Procedures.

Furnish the information required by Items 307 of Regulation S-K (17 CFR 229.307) and 308(c) of Regulation S-K (17 CFR 229.308(c)).

* * * * *

22. By amending Form 10-QSB (referenced in §249.308b) by:

- a. Removing the last sentence of paragraph 2 of General Instruction F;
- b. Revising Item 3 to "Part I - Financial Information;" and
- c. Removing the "Certifications" section after the "Signatures" section.

The revision reads as follows.

Note: The text of Form 10-QSB does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM 10-QSB

* * * * *

Part I - Financial Information

* * * * *

Item 3. Controls and Procedures.

Furnish the information required by Items 307 of Regulation S-B (17 CFR 228.307) and 308(c) of Regulation S-B (17 CFR 228.308(c)).

* * * * *

23. By amending Form 10-K (referenced in § 249.310) by:

- a. Removing the phrase "(who also must provide the certification required by Rule 13a-14 (17 CFR 240.13a-14) or Rule 15d-14 (17 CFR 240.15d-14) exactly as specified in this form)" each time it appears in the first sentence of paragraph (2)(a) of General Instruction D.;
- b. Removing the phrase "(Items 1 through 9 or any portion thereof)" and adding, in its place, the phrase "(Items 1 through 9A or any portion thereof)" in the first sentence of paragraph (2) of General Instruction G.;
- c. Removing the phrase "(Items 10, 11, 12 and 13)" and adding, in its place, the phrase "(Items 10, 11, 12, 13 and 14)" in the first sentence of paragraph (3) of General Instruction G.;
- d. Removing the phrase "(Items 1 through 9)" in the third sentence of paragraph (4) of General Instruction G and adding, in its place, the phrase "(Items 1 through 9A)";
- e. Removing the phrase "(Items 10 through 13)" in the third sentence of paragraph (4) of General Instruction G and adding, in its place, the phrase "(Items 10 through 14)";
- f. Redesignating Item 14 of Part III as Item 9A of Part II and revising newly redesignated Item 9A;
- g. Redesignating Item 15 in Part III as Item 14;
- h. "Instruction to Item 15" is corrected to read "Instruction to Item 14";
- i. Redesignating Item 16 in Part IV as Item 15;
- j. Removing the "Certifications" section after the "Signatures" section and before the reference to "Supplemental Information to be Furnished With Reports Filed Pursuant to Section 15(d) of the Act by Issuers Which Have Not Registered Securities Pursuant to Section 12 of the Act."

The revision reads as follows.

Note: The text of Form 10-K does not, and this amendment will not,

appear in the Code of Federal Regulations.

Form 10-K

* * * * *

PART II

* * * * *

Item 9A. Controls and procedures.

Furnish the information required by Items 307 and 308 of Regulation S-K (17 CFR 229.307 and 229.308).

24. By amending Form 10-KSB (referenced in § 249.310b) by:

- a. Removing the phrase "(who also must provide the certification required by Rule 13a-14 (17 CFR 240.13a-14) or Rule 15d-14 (17 CFR 240.15d-14) exactly as specified in this form)" each time it appears in the first sentence of paragraph 2 of General Instruction C.;
- b. Redesignating Item 14 of Part III as Item 8A of Part II and revising newly redesignated Item 8A;
- c. Redesignating Item 15 of Part III as Item 14;
- d. "Instruction to Item 15" is corrected to read "Instruction to Item 14";
- e. Revising Item 2 of Part III of "INFORMATION REQUIRED IN ANNUAL REPORT OF TRANSITIONAL SMALL BUSINESS ISSER"; and
- f. Removing the "Certifications" section after the "Signatures" section and before the reference to "Supplemental Information to be Furnished With Reports Filed Pursuant to Section 15(d) of the Exchange Act By Non-reporting Issuers."

Note: The text of Form 10-KSB does not, and this amendment will not, appear in the Code of Federal Regulations.

Form 10-KSB

* * * * *

PART II

* * * * *

Item 8A. Controls and Procedures

Furnish the information required by Items 307 of Regulation S-B (17 CFR 228.307) and 308 of Regulation S-B (17 CFR 228.308).

* * * * *

INFORMATION REQUIRED IN ANNUAL REPORT OF TRANSITIONAL SMALL BUSINESS ISSER

* * * * *

PART III

* * * * *

Item 2. Description of Exhibits.

As appropriate, the issuer should file those documents required to be filed as Exhibit Number 2, 3, 5, 6, and 7 in Part III of Form 1-A. The registrant also shall file:

(12) Additional exhibits - Any additional exhibits which the issuer may wish to file, which shall be so marked as to indicate clearly the subject matters to which they refer.

(13) Form F-X - Canadian issuers shall file a written irrevocable consent and power of attorney on Form F-X.

(31) The exhibit described in paragraph (b)(31) of Item 601 of Regulation S-B.

(32) The exhibit described in paragraph (b)(32) of Item 601 of Regulation S-B.

25. By amending Form 20-F (referenced in §249.220f) by:

- a. Revising paragraph (e) to General Instruction B;
- b. Revising Item 15 of Part II;
- c. Removing the phrase "internal controls and procedures for financial reporting" in paragraph (b)(4) of Item 16A of Part II and adding, in its place, the phrase "internal control over financial reporting";
- d. Removing the "Certifications" section after the "Signatures" section and before the section referencing "Instructions as to Exhibits"; and

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

e. In the "Instruction as to Exhibits" section, redesignate paragraph 12 as paragraph 14 and add new paragraph 12 and paragraph 13.

The revisions and addition read as follows.

Note: The text of Form 20-F does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM 20-F

* * * * *

GENERAL INSTRUCTIONS

* * * * *

B. General Rules and Regulations That Apply to this Form.

* * * * *

(e) Where the Form is being used as an annual report filed under Section 13(a) or 15(d) of the Exchange Act, provide the certifications required by Rule 13a-14 (17 CFR 240.13a-14) or Rule 15d-14 (17 CFR 240.15d-14).

* * * * *

PART II

* * * * *

Item 15. Controls and Procedures.

(a) Disclosure Controls and Procedures. Where the Form is being used as an annual report filed under Section 13(a) or 15(d) of the Exchange Act, disclose the conclusions of the issuer's principal executive and principal financial officers, or persons performing similar functions, regarding the effectiveness of the issuer's disclosure controls and procedures (as defined in 17 CFR 240.13a-15(e) or 240.15d-15(e)) as of the end of the period covered by the report, based on the evaluation of these controls and procedures required by paragraph (b) of 17 CFR 240.13a-15 or 240.15d-15.

(b) Management's annual report on internal control over financial reporting. Where the Form is being used as an annual report filed under Section 13(a) or 15(d) of the Exchange Act, provide a report of management on the issuer's internal control over financial reporting (as defined in 17 CFR 240.13a-15(f) or 240.15d-15(f)) that contains:

(1) A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the issuer;

(2) A statement identifying the framework used by management to evaluate the effectiveness of the issuer's internal control over financial reporting as required by paragraph (c) of 17 CFR 240.13a-15 or 240.15d-15;

(3) Management's assessment of the effectiveness of the issuer's internal control over financial reporting as of the end of the issuer's most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective. This discussion must include disclosure of any material weakness in the issuer's internal control over financial reporting identified by management. Management is not permitted to conclude that the issuer's internal control over financial reporting is effective if there are one or more material weaknesses in the issuer's internal control over financial reporting; and

(4) A statement that the registered public accounting firm that audited the financial statements included in the annual report containing the disclosure required by this Item has issued an attestation report on management's assessment of the issuer's internal control over financial reporting.

(c) Attestation report of the registered public accounting firm. Where the Form is being used as an annual report filed under Section 13(a) or 15(d) of the Exchange Act, provide the registered public accounting firm's attestation report on management's assessment of the issuer's internal control over financial reporting in the issuer's annual report containing the disclosure required by this Item.

(d) Changes in internal control over financial reporting. Disclose any change in the issuer's internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of 17 CFR 240.13a-15 or 240.15d-15 that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.

Instructions to Item 15.

1. The issuer must maintain evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of the issuer's internal control over financial reporting.

2. An issuer that is an Asset-Backed Issuer (as defined in 17 CFR 240.13a-14(g) and 17 CFR 240.15d-14(g)) is not required to disclose the information required by this Item.

* * * * *

Instructions as to Exhibits

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

* * * * *

12. The certifications required by Rule 13a-14(a) (17 CFR 240.13a-14(a)) or Rule 15d-14(a) (17 CFR 240.15d-14(a)) exactly as set forth below:

CERTIFICATIONS*

I, [identify the certifying individual], certify that:

1. I have reviewed this annual report on Form 20-F of [identify company];
2. 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;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the company as of, and for, the periods presented in this report;
4. The company's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the company and have:

(a) 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 company, 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;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

(c) Evaluated the effectiveness of the company'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; and

(d) Disclosed in this report any change in the company's internal control over financial reporting that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting; and

5. The company's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the company's auditors and the audit committee of the company's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the company's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal control over financial reporting.

Date:

[Signature]
[Title]

* Provide a separate certification for each principal executive officer and principal financial officer of the company. See Rules 13a-14(a) and 15d-14(a).

13. (a) The certifications required by Rule 13a-14(b) (17 CFR 240.13a-14(b)) or Rule 15d-14(b) (17 CFR 240.15d-14(b)) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350).

(b) A certification furnished pursuant to Rule 13a-14(b) (17 CFR 240.13a-14(b)) or Rule 15d-14(b) (17 CFR 240.15d-14(b)) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350) will not be deemed "filed" for purposes of Section 18 of the Exchange Act [15 U.S.C. 78r], or otherwise subject to the liability of that section. Such certification will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that the company specifically incorporates it by reference.

26. By amending Form 40-F (referenced in §249.240f) by:

- a. Revising paragraph (6) to General Instruction B; and

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

b. Removing the phrase "internal controls and procedures for financial reporting" and adding, in its place, the phrase "internal control over financial reporting" in paragraph (8)(b)(4) of General Instruction B; and

c. Removing the "Certifications" section after the "Signatures" section.

The revision reads as follows.

Note: The text of Form 40-F does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM 40-F

* * * * *

GENERAL INSTRUCTIONS

* * * * *

B. Information To Be Filed on this Form

* * * * *

(6) Where the Form is being used as an annual report filed under Section 13(a) or 15(d) of the Exchange Act:

(a) (1) Provide the certifications required by Rule 13a-14(a) (17 CFR 240.13a-14(a)) or Rule 15d-14(a) (17 CFR 240.15d-14(a)) as an exhibit to this report exactly as set forth below.

CERTIFICATIONS*

I, [identify the certifying individual], certify that:

1. I have reviewed this annual report on Form 40-F of [identify issuer];
2. 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;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in this report;
4. The issuer's other certifying officer(s) and I are responsible for

establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the issuer and have:

(a) 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 issuer, 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;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

(c) Evaluated the effectiveness of the issuer'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; and

(d) Disclosed in this report any change in the issuer's internal control over financial reporting that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting; and

5. The issuer's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the issuer's auditors and the audit committee of the issuer's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the issuer's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal control over financial reporting.

Date:

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

[Signature]
[Title]

* Provide a separate certification for each principal executive officer and principal financial officer of the issuer. See Rules 13a-14(a) and 15d-14(a).

(2) (i) Provide the certifications required by Rule 13a-14(b) (17 CFR 240.13a-14(b)) or Rule 15d-14(b) (17 CFR 240.15d-14(b)) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350) as an exhibit to this report.

(ii) A certification furnished pursuant to Rule 13a-14(b) (17 CFR 240.13a-14(b)) or Rule 15d-14(b) (17 CFR 240.15d-14(b)) and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350) will not be deemed "filed" for purposes of Section 18 of the Exchange Act [15 U.S.C. 78r], or otherwise subject to the liability of that section. Such certification will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that the issuer specifically incorporates it by reference.

(b) Disclosure Controls and Procedures. Where the Form is being used as an annual report filed under Section 13(a) or 15(d) of the Exchange Act, disclose the conclusions of the issuer's principal executive and principal financial officers, or persons performing similar functions, regarding the effectiveness of the issuer's disclosure controls and procedures (as defined in 17 CFR 240.13a-15(e) or 240.15d-15(e)) as of the end of the period covered by the report, based on the evaluation of these controls and procedures required by paragraph (b) of 17 CFR 240.13a-15 or 240.15d-15.

(c) Management's annual report on internal control over financial reporting. Where the Form is being used as an annual report filed under Section 13(a) or 15(d) of the Exchange Act, provide a report of management on the issuer's internal control over financial reporting (as defined in 17 CFR 240.13a-15(f) or 240.15d-15(f)) that contains:

(1) A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the issuer;

(2) A statement identifying the framework used by management to evaluate the effectiveness of the issuer's internal control over financial reporting as required by paragraph (c) of 17 CFR 240.13a-15 or 240.15d-15;

(3) Management's assessment of the effectiveness of the issuer's internal control over financial reporting as of the end of the issuer's most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective. This discussion must include disclosure of any material weakness in the issuer's internal control over financial reporting identified by management. Management is not permitted to conclude that the issuer's internal control over financial reporting is effective if there are one or more material weaknesses in the issuer's internal control over financial

reporting; and

(4) A statement that the registered public accounting firm that audited the financial statements included in the annual report containing the disclosure required by this Item has issued an attestation report on management's assessment of the issuer's internal control over financial reporting.

(d) Attestation report of the registered public accounting firm. Where the Form is being used as an annual report filed under Section 13(a) or 15(d) of the Exchange Act, provide the registered public accounting firm's attestation report on management's assessment of internal control over financial reporting in the annual report containing the disclosure required by this Item.

(e) Changes in internal control over financial reporting. Disclose any change in the issuer's internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of 17 CFR 240.13a-15 or 240.15d-15 that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.

Instructions to paragraphs (b), (c), (d) and (e) of General Instruction B. 6.

1. The issuer must maintain evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of the issuer's internal control over financial reporting.

2. An issuer that is an Asset-Backed Issuer (as defined in 17 CFR 240.13a-14(g) and 240.15d-14(g)) is not required to disclose the information required by this Item.

* * * * *

PART 270 - RULES AND REGULATIONS, INVESTMENT COMPANY ACT OF 1940

27. The authority citation for Part 270 is amended by revising the subauthority citation for "Section 270.30a-2" to read as follows:

Authority: 15 U.S.C. 80a-1 et seq., 80a-34(d), 80a-37, and 80a-39, unless otherwise noted.

* * * * *

Section 270.30a-2 is also issued under 15 U.S.C. 78m, 78o(d), 80a-8, 80a-29, 7202, and 7241; and 18 U.S.C. 1350, unless otherwise noted.

* * * * *

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

28. By revising the last sentence of §270.8b-15 to read as follows:

§270.8b-15 Amendments.

* * * An amendment to any report required to include the certifications as specified in §270.30a-2(a) must include new certifications by each principal executive and principal financial officer of the registrant, and an amendment to any report required to be accompanied by the certifications as specified in §240.13a-14(b) or §240.15d-14(b) and §270.30a-2(b) must be accompanied by new certifications by each principal executive and principal financial officer of the registrant.

29. Section 270.30a-2 is revised to read as follows:

§270.30a-2 Certification of Form N-CSR.

(a) Each report filed on Form N-CSR (§§249.331 and 274.128 of this chapter) by a registered management investment company must include certifications in the form specified in Item 10(a)(2) of Form N-CSR and such certifications must be filed as an exhibit to such report. Each principal executive and principal financial officer of the investment company, or persons performing similar functions, at the time of filing of the report must sign a certification.

(b) Each report on Form N-CSR filed by a registered management investment company under Section 13(a) or 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78m(a) or 78o(d)) and that contains financial statements must be accompanied by the certifications required by Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350) and such certifications must be furnished as an exhibit to such report as specified in Item 10(b) of Form N-CSR. Each principal executive and principal financial officer of the investment company (or equivalent thereof) must sign a certification. This requirement may be satisfied by a single certification signed by an investment company's principal executive and principal financial officers.

(c) A person required to provide a certification specified in paragraph (a) or (b) of this section may not have the certification signed on his or her behalf pursuant to a power of attorney or other form of confirming authority.

30. By revising §270.30a-3 to read as follows:

§ 270.30a-3 Controls and procedures.

(a) Every registered management investment company, other than a small business investment company registered on Form N-5 (§§239.24 and 274.5 of this chapter), must maintain disclosure controls and procedures (as defined in paragraph (c) of this section) and internal control over financial reporting (as defined in paragraph (d) of this section).

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

(b) Each such registered management investment company's management must evaluate, with the participation of the company's principal executive and principal financial officers, or persons performing similar functions, the effectiveness of the company's disclosure controls and procedures, within the 90-day period prior to the filing date of each report on Form N-CSR (§§ 249.331 and 274.128 of this chapter).

(c) For purposes of this section, the term disclosure controls and procedures means controls and other procedures of a registered management investment company that are designed to ensure that information required to be disclosed by the investment company on Form N-CSR (§§249.331 and 274.128 of this chapter) 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 investment company in the reports that it files or submits on Form N-CSR is accumulated and communicated to the investment company's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

(d) The term internal control over financial reporting is defined as a process designed by, or under the supervision of, the registered management investment company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company'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:

(1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the investment company;

(2) 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 investment company are being made only in accordance with authorizations of management and directors of the investment company; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the investment company's assets that could have a material effect on the financial statements.

PART 249 - FORMS, SECURITIES EXCHANGE ACT OF 1934

PART 274 - FORMS PRESCRIBED UNDER THE INVESTMENT COMPANY ACT OF

1940

31. The authority citation for Part 274 is amended by revising the authority citation for "Section 274.128" to read as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 78c(b), 78l, 78m, 78n, 78o(d), 80a-8, 80a-24, 80a-26, and 80a-29, unless otherwise noted.

* * * * *

Section 274.128 is also issued under 15 U.S.C. 78j-1, 7202, 7233, 7241, 7264, and 7265; and 18 U.S.C. 1350.

32. Form N-SAR (referenced in §§ 249.330 and 274.101) is amended by revising the reference "internal controls and procedures for financial reporting" in paragraph (b)(6)(iv) of the Instruction to Sub-Item 102P3 to read "internal control over financial reporting".

33. Form N-CSR (referenced in §§ 249.331 and 274.128) is amended by:

a. In General Instruction D, revising the reference "Items 4, 5, and 10(a)" to read "Items 4, 5, and 10(a)(1)";

b. Revising paragraph 2.(a) of General Instruction F;

c. In paragraph (c) of Item 2, revising the reference "Item 10(a)" to read "Item 10(a)(1)";

d. In paragraph (f)(1) of Item 2, revising the reference "Item 10(a)" to read "Item 10(a)(1)";

e. In paragraph (b)(4) of Item 3, revising the reference "internal controls and procedures for financial reporting" to read "internal control over financial reporting";

f. Revising Item 9; and

g. In Item 10:

(i) The introductory text and paragraphs (a) and (b) are redesignated as paragraphs (a), (a)(1) and (a)(2), respectively;

(ii) Revising newly redesignated paragraph (a) and newly redesignated paragraph (a)(2); and

(iii) Adding new paragraph (b) and an Instruction to Item 10.

The revisions and additions read as follows.

Note: The text of Form N-CSR does not, and these amendments will not, appear in the Code of Federal Regulations.

FORM N-CSR

* * * * *

GENERAL INSTRUCTIONS

* * * * *

F. Signature and Filing of Report.

* * * * *

2. (a) The report must be signed by the registrant, and on behalf of the registrant by its principal executive and principal financial officers.

* * * * *

Item 9. Controls and Procedures.

(a) Disclose the conclusions of the registrant's principal executive and principal financial officers, or persons performing similar functions, regarding the effectiveness of the registrant's disclosure controls and procedures (as defined in Rule 30a-3(c) under the Act (17 CFR 270.30a-3(c))) as of a date within 90 days of the filing date of the report that includes the disclosure required by this paragraph, based on the evaluation of these controls and procedures required by Rule 30a-3(b) under the Act (17 CFR 270.30a-3(b)) and Rules 13a-15(b) or 15d-15(b) under the Exchange Act (17 CFR 240.13a-15(b) or 240.15d-15(b)).

(b) Disclose any change in the registrant's internal control over financial reporting (as defined in Rule 30a-3(d) under the Act (17 CFR 270.30a-3(d)) that occurred during the registrant's last fiscal half-year (the registrant's second fiscal half-year in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.

Item 10. Exhibits.

(a) File the exhibits listed below as part of this Form.

* * * * *

(a)(2) A separate certification for each principal executive and principal

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

financial officer of the registrant as required by Rule 30a-2(a) under the Act (17 CFR 270.30a-2(a)), exactly as set forth below:

CERTIFICATIONS

I, [identify the certifying individual], certify that:

1. I have reviewed this report on Form N-CSR of [identify registrant];
2. 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;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations, changes in net assets, and cash flows (if the financial statements are required to include a statement of cash flows) of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Rule 30a-3(c) under the Investment Company Act of 1940) and internal control over financial reporting (as defined in Rule 30a-3(d) under the Investment Company Act of 1940) for the registrant and have:
 - (a) 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;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;
 - (c) 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 a date within 90 days prior to the filing date of this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal half-year (the registrant's second fiscal half-year in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

5. The registrant's other certifying officer(s) and I have disclosed to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

- (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize, and report financial information; and
- (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date:

[Signature]
[Title]

(b) If the report is filed under Section 13(a) or 15(d) of the Exchange Act, provide the certifications required by Rule 30a-2(b) under the Act (17 CFR 270.30a-2(b)), Rule 13a-14(b) or Rule 15d-14(b) under the Exchange Act (17 CFR 240.13a-14(b) or 240.15d-14(b)), and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. 1350) as an exhibit. A certification furnished pursuant to this paragraph will not be deemed "filed" for purposes of

Section 18 of the Exchange Act (15 U.S.C. 78r), or otherwise subject to the liability of that section. Such certification will not be deemed to be incorporated by reference into any filing under the Securities Act of 1933 or the Exchange Act, except to the extent that the registrant specifically incorporates it by reference.

Instruction to Item 10.

Letter or number the exhibits in the sequence that they appear in this item.

* * * * *

By the Commission.

J. Lynn Taylor
Assistant Secretary

June 5, 2003

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

- [1](#) 17 CFR 228.10 [et seq.](#)
- [2](#) 17 CFR 229.10 [et seq.](#)
- [3](#) 17 CFR 249.310.
- [4](#) 17 CFR 249.310b.
- [5](#) 17 CFR 249.308a.
- [6](#) 17 CFR 249.308b.
- [7](#) 17 CFR 249.220f.
- [8](#) 17 CFR 249.240f.
- [9](#) 17 CFR 240.12b-15.
- [10](#) 17 CFR 240.13a-14.
- [11](#) 17 CFR 240.13a-15.
- [12](#) 17 CFR 140.15d-14.
- [13](#) 17 CFR 240.15d-15.
- [14](#) 15 U.S.C. 78a [et seq.](#)
- [15](#) 17 CFR 210.1-02 and 2-02.
- [16](#) 17 CFR 210.1-01 [et seq.](#)
- [17](#) 17 CFR 270.8b-15.
- [18](#) 17 CFR 270.30a-2.
- [19](#) 17 CFR 270.30a-3.
- [20](#) 15 U.S.C. 80a-1 [et seq.](#)
- [21](#) 17 CFR 249.331; 17 CFR 274.128.
- [22](#) 17 CFR 249.330; 17 CFR 274.101.
- [23](#) Pub. L. 107-204, 116 Stat. 745 (2002).
- [24](#) Section 404 of the Sarbanes-Oxley Act does not apply to any registered investment company due to an exemption in Section 405 of the Sarbanes-Oxley Act. See sec. 405 of Pub. L. 107-204, 116 Stat. 745 (2002).
- [25](#) On April 25, 2003, the Commission approved the PCAOB's adoption of the auditing and attestation standards in existence as of April 16, 2003 as interim auditing and attestation standards. See Release No. 33-8222 (Apr. 25, 2003) [68 FR 23335].
- [26](#) Release No. 33-8138 (Oct. 22, 2002) [67 FR 66208] ("Proposing Release"). The public comments we received can be viewed in our Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549, in File No. S7-40-02. Public comments submitted by electronic mail are available on our website, www.sec.gov.

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

- [27](#) The commenters on File No. S7-40-02 are as follows: [Academics](#) Paul Walker, Ph. D., CPA; [Accounting Firms](#) BDO Seidman, LLP; Deloitte & Touche LLP; Ernst & Young LLP; KPMG LLP; PricewaterhouseCoopers LLP; [Associations](#) America's Community Bankers; American Bankers Association; American Bar Association; American Corporate Counsel Association; American Institute of Certified Public Accountants; Association for Financial Professionals; the Association of the Bar of the City of New York; Association for Investment Management and Research; the Business Roundtable; Community Bankers Association of New York State; Edison Electric Institute; Financial Executives International; Independent Community Bankers of America; the Institute of Internal Auditors; Maine Bankers Association; Manufacturers Alliance/MAPI Inc.; Massachusetts Bankers Association; National Association of Real Estate Investment Trusts; New York Bankers Association; New York County Lawyers' Association; New York State Bar Association; Software & Information Industry Association; Software Finance and Tax Executives Council; Wisconsin Bankers Association; [Corporations](#) Cardinal Health, Inc.; Compass Bancshares, Inc.; Computer Sciences Corporation; Eastman Kodak Company; Eli Lilly and Company; Emerson Electric Co.; Executive Responsibility Advisors, LLC; Greif Bros.; Intel Corporation; International Paper Company; Protiviti; [Government Entities](#) Federal Reserve Bank of Atlanta; Small Business Administration; [Law Firms](#) Dykema Gossett PLLC; Karr Tuttle Campbell; Fried, Frank, Harris, Shriver and Jacobson; Sutherland, Asbill & Brennan LLP; [Individuals](#) Thomas Damman; D. Scott Huggins; Tim J. Leech; Simon Lorne; Ralph Saul; Lee Squire; Robert J. Stuckey; [Foreign Companies](#) Siemens Aktiengesellschaft; [International Entities](#) British Bankers Association; British Embassy; Canadian Bankers Association; Confederation of British Industry; European Commission; Institute of Chartered Accountants of England and Wales.
- [28](#) 15 U.S.C. 78m(a) or 78o(d). Section 13(a) of the Exchange Act requires every issuer of a security registered pursuant to Section 12 of the Exchange Act [15 U.S.C. 78j] to file with the Commission such annual reports and such quarterly reports as the Commission may prescribe. Section 15(d) of the Exchange Act requires each issuer that has filed a registration statement that has become effective pursuant to the Securities Act of 1933 [15 U.S.C. 77a [et seq.](#)] (the "Securities Act") to file such supplementary and periodic information, documents and reports as may be required pursuant to Section 13 in respect of a security registered pursuant to Section 12, unless the duty to file under Section 15(d) has been suspended for any fiscal year. See Exchange Act Rule 12h-3 [17 CFR 240.12h-3].
- [29](#) 18 U.S.C. 1350.
- [30](#) See Release No. 34-46300 (Aug. 2, 2002) [67 FR 51508] at n. 11, containing supplemental information on the Commission's original certification proposal in light of the enactment of the Sarbanes-Oxley Act of 2002.
- [31](#) See Release No. 33-8124 (Aug. 28, 2002) [67 FR 57276] .
- [32](#) See Release No. IC-25914 (Jan. 27, 2003) [68 FR 5348].
- [33](#) See Release No. 33-8212 (Mar. 21, 2003) [68 FR 15600].
- [34](#) These methods have included: (1) submitting the statement as non-public paper correspondence; (2) submitting the statement as non-public electronic correspondence with the EDGAR filing of the periodic report; (3) submitting the statement under (1) or (2) above supplemented by an Item 9 Form 8-K report so that the statement is publicly available; (4) submitting the statement as an exhibit to the periodic report; and (5) submitting the statement in the text of the periodic report (typically, below the signature block for the report).

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

- [35](#) We proposed to use this term throughout the rules implementing the annual internal control report requirements of Section 404 of the Sarbanes-Oxley Act, as well as the revised Sarbanes-Oxley Section 302 certification requirements, to complement the defined term "disclosure controls and procedures" referred to in the Section 302 requirements. Congress used the term "internal controls" in Section 302 and "internal control structure and procedures for financial reporting" in Section 404.
- [36](#) For a history of the development of internal control standards, see Steven J. Root, Beyond COSO-Internal Control to Enhance Corporate Governance (1998).
- [37](#) In 1941, the Commission adopted amendments to Rules 2-02 and 3-07 of Regulation S-X that formally codified this practice. See Accounting Series Release No. 21 (Feb. 5, 1941) [11 FR 10921].
- [38](#) An early definition for the term appeared in Internal Control--Elements Of a Coordinated System and Its Importance to Management and the Independent Public Accountant, a report published in 1949 by the American Institute of Accountants, the predecessor to the American Institute of Certified Public Accountants ("AICPA"). The report defined internal control to mean "the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies." Subsequent definitions of the term attempted to clarify the distinction by labeling the controls relevant to an audit as "internal accounting controls" and the non-accounting controls as "administrative controls." The AICPA officially dropped these distinctions in 1988. See Root, at p. 76.
- [39](#) Title I of Pub. Law No. 95-213 (1977). Beginning in 1973, as a result of the work of the Office of the Watergate Special Prosecutor, the Commission became aware of a pattern of conduct involving the use of corporate funds for illegal domestic political contributions. A subsequent Commission investigation revealed that instances of undisclosed questionable or illegal corporate payments--both domestic and foreign--were widespread. On May 12, 1976, the Commission submitted to the Senate Banking, Housing and Urban Affairs Committee a report entitled Report on Questionable and Illegal Corporate Payments and Practices. The report described and analyzed the Commission's investigation concerning improper corporate payments and outlined legislative and other responses that the Commission recommended to remedy these problems. One of the Commission's recommendations was that Congress enact legislation aimed expressly at enhancing the accuracy of the corporate books and records and the reliability of the audit process.
- [40](#) See Exchange Act Section 13(b)(2) [15 U.S.C. 78m(b)(2)].
- [41](#) The Treadway Commission was sponsored by the AICPA, the American Accounting Association, the Financial Executives International (formerly Financial Executives Institute), the Institute of Internal Auditors and the Institute of Management Accountants (formerly the National Association of Accountants). The Treadway Commission's report, the Report of the National Commission on Fraudulent Financial Reporting (Oct. 1987), is available at www.coso.org.
- [42](#) See COSO, Internal Control-Integrated Framework (1992) ("COSO Report"). In 1994, COSO published an addendum to the Reporting to External Parties volume of the COSO Report. The addendum discusses the issue of, and provides a vehicle for, expanding the scope of a public management report on internal control to address additional controls pertaining to safeguarding of assets. In 1996, COSO issued a supplement to its original framework to address the application of internal control over financial derivative activities.

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

- [43](#) Auditing Standards Board, AICPA, Statement on Auditing Standards No. 78, Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55 (1995).
- [44](#) See letters regarding File No. S7-40-02 of: America's Community Bankers ("ACB"); American Corporate Counsel Association ("ACCA"); American Institute of Certified Public Accountants ("AICPA"); Compass Bancshares, Inc. ("Compass"); Computer Sciences Corporation ("CSC"); the Edison Electric Institute ("EEI"); the Independent Community Bankers of America ("ICBA"); the Institute of Internal Auditors ("IIA"); the Association of the Bar of the City of New York, Committee on Corporate Law ("NYCB-CCL"); Protiviti; and Siemens AG.
- [45](#) See letters regarding File No. S7-40-02 of ACB and ICBA.
- [46](#) See letters regarding File No. S7-40-02 of: the American Bar Association, Committee on the Federal Regulation of Securities and the Committee on Law and Accounting ("ABA"); the Federal Reserve Bank of Atlanta ("FED"); IIA; Simon Lorne ("Lorne"); and Pricewaterhouse Coopers LLP ("PwC").
- [47](#) See ABA letter regarding File No. S7-40-02.
- [48](#) See letters regarding File No. S7-40-02 of: AICPA; Compass; Deloitte & Touche LLP ("D&T"); IIA; KPMG LLP ("KPMG"); and PwC.
- [49](#) See new Item 308 of Regulations S-K and S-B, amended Items 1-02 and 2-02 of Regulation S-X; amended Items 307 and 401 of Regulations S-K and S-B; amended Exchange Act Rules 13a-14, 13a-15, 15d-14 and 15d-15; and amended Forms 20-F and 40-F.
- [50](#) The COSO Report states that the composition of a company's board and audit committee, and how the directors fulfill their responsibilities related to the financial reporting process, are key aspects of the company's control environment. An important element of the company's internal control over financial reporting "... is the involvement of the board or audit committee in overseeing the financial reporting process, including assessing the reasonableness of management's accounting judgments and estimates and reviewing key filings with regulatory agencies." See COSO Report at 130. The Commission similarly has stated in the past that both a company's management and board have important roles to play in establishing a supportive control environment. In its 1981 Statement of Policy regarding the FCPA, the Commission stated, "In the last analysis, the key to an adequate 'control environment' is an approach on the part of the board and top management which makes clear what is expected and that conformity to these expectations will be rewarded while breaches will be punished." See Release No. 34-17500 (Jan. 29, 1981) [46 FR 11544].
- [51](#) See amended Exchange Act Rules 13a-14(d) and 15d-14(d). The scope of the term "preparation of financial statements in accordance with generally accepted accounting principles" in the definition encompasses financial statements prepared for regulatory reporting purposes.
- [52](#) Codification of Statements on Auditing Standards Section 317 requires auditors to consider a company's compliance with laws and regulations that have a direct and material effect on the financial statements.
- [53](#) 15 U.S.C. 78m(b)(2)(B).

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

- 54** Section 103 of the Sarbanes-Oxley Act requires the PCAOB to establish by rule standards to be used by registered public accounting firms in the preparation and issuance of audit reports. In carrying out this responsibility, the PCAOB must include in the auditing standards that it adopts, among other things: a requirement that each registered public accounting firm describe in each audit report the scope of its testing of the company's internal control structure and procedures performed in fulfilling its internal control evaluation and reporting required by Section 404(b) of the Sarbanes-Oxley Act; present in the audit report (or attestation report) its findings from such testing; and an evaluation of whether the company's internal control structure and procedures: (1) include maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the company's assets; and (2) 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 company are being made only in accordance with the authorization of management and directors of the company. In the audit report (or attestation report), the registered public accounting firm also must describe, at a minimum, material weaknesses in such internal controls and any material noncompliance found on the basis of such testing. See Sections 103(a)(2)(A)(iii)(I), (II) and (III) of the Sarbanes-Oxley Act. See also, Interim Professional Attestation Standards Rule 3300T, adopted in PCAOB Release No. 2003-006 (Apr. 18, 2003), and approved by the Commission on April 25, 2003.
- 55** Control procedures were described as policies and procedures in addition to the control environment and accounting system that management established to provide reasonable assurance that specific entity objectives will be achieved. SAS 55 also states that control procedures may generally be categorized as procedures that include, among other things, "adequate safeguards over access to and use of assets and records, such as secured facilities and authorization for access to computer programs and data files." See Statement on Auditing Standards No. 55, paragraph no. 11.
- 56** See COSO "Addendum to Reporting to External Parties," Internal Control-Integrated Framework, (1994) ("1994 Addendum") at p. 154.
- 57** The COSO Report states: "Although these [objectives relating to safeguarding of resources] are primarily operations objectives, certain aspects of safeguarding can fall under other categories. . . [T]he goal of ensuring that any such asset losses are properly reflected in the entity's financial statements represents a financial reporting objective." The category in which an objective falls can sometimes depend on the circumstances. Continuing the discussion of safeguarding of assets, controls to prevent theft of assets - such as maintaining a fence around inventory and a gatekeeper verifying proper authorization of requests for movement of goods - fall under the operations category. These controls normally would not be relevant to the reliability of financial statement preparation, because any inventory losses would be detected pursuant to periodic physical inspection and recorded in the financial statements. However, if for financial reporting purposes management relies solely on perpetual inventory records, as may be the case for interim reporting, the physical security controls would then also fall within the financial reporting category. This is because these physical security controls, along with other controls over the perpetual inventory records, would be needed to ensure reliable financial reporting. Id. at 37.

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

- 58** As stated in n. 1 to the 1994 Addendum, the FCPA requires companies, among other things, to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that (i) transactions are executed in accordance with management's general or specific authorization; (ii) transactions are recorded as necessary ... to maintain accountability for assets; (iii) access to assets is permitted only in accordance with management's general or specific authorization; and (iv) the recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences."
- 59** See letters regarding File No. S7-40-02 of: ABA; CSC; EEI; FED; Eastman Kodak Co. ("Kodak"); KPMG; Protiviti; and PwC.
- 60** See letters regarding File No. S7-40-02 of: ACCA and Financial Executives Institute ("FEI").
- 61** See letters regarding File No. S7-40-02 of: AICPA; BDO Seidman, LLP ("BDO"); D&T; Ernst & Young LLP ("E&Y"); KPMG; and PwC.
- 62** Management must state whether or not the company's internal control over financial reporting is effective. A negative assurance statement indicating that nothing has come to management's attention to suggest that the company's internal control over financial reporting is not effective will not be acceptable.
- 63** A "material weakness" is defined in Statement on Auditing Standards No. 60 (codified in Codification of Statements on Auditing Standards AU §325) as a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by errors or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. See discussion in Section II.B.3.b. below.
- 64** See new Item 308 of Regulations S-B and S-K, Item 15 of Form 20-F and General Instruction B(6) of Form 40-F.
- 65** Many commenters cited the absence of evaluative criteria in AU §319 in their arguments against the reference to AU §319 in our proposed definition of "internal controls and procedures for financial reporting."
- 66** See amended Exchange Act Rule 13a-15(c) or 15d-15(c), amended Item 15 of Form 20-F and amended General Instruction (B) to Form 40-F.
- 67** The Guidance on Assessing Control published by the Canadian Institute of Chartered Accountants and the Turnbull Report published by the Institute of Chartered Accountants in England & Wales are examples of other suitable frameworks.
- 68** We are aware that some of the evaluation frameworks used to assess a foreign company's internal controls in its home country do not require a statement regarding whether the company's system of internal control has been effective. Under our final rules, management of a foreign reporting company who relies on such an evaluation framework used in its home country is nevertheless under an obligation to state affirmatively whether its company's internal controls are, or are not, effective.
- 69** See AT §101, paragraph 24.
- 70** See Release No. 33-8183 (Jan. 28, 2003) [68 FR 6006].

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

- [71](#) Management's acceptance of responsibility for the documentation and testing performed by the auditor does not satisfy the auditor independence rules.
- [72](#) This is consistent with interim attestation standards. See AT §501.
- [73](#) The term "significant deficiency" has the same meaning as the term "reportable condition" as used in AU §325 and AT §501. The terms "material weakness" and "significant deficiency" both represent deficiencies in the design or operation of internal control that could adversely affect a company's ability to record, process, summarize and report financial data consistent with the assertions of management in the company's financial statements, with a "material weakness" constituting a greater deficiency than a "significant deficiency." Because of this relationship, it is our judgment that an aggregation of significant deficiencies could constitute a material weakness in a company's internal control over financial reporting.
- [74](#) See new Item 308(d) of Regulations S-B and S-K.
- [75](#) See, for example, letters re: File No. S7-40-02 of: ABA; AICPA; BDO; Intel; and Eli Lilly and Company.
- [76](#) Section 13(b)(2)(A) of the Exchange Act [15 U.S.C. 78m(b)(2)(A)] requires companies to "make and keep books, records, and accounts, which in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer." See also Section 13(b)(2)(B) of the Exchange Act [15 U.S.C. 78m(b)(2)(B)] and *In re Microsoft Corp.*, Administrative Proceeding File No. 3-10789 (June 3, 2002). In the *Microsoft* order, the Commission stated that such books and records include not only general ledgers and accounting entries, but also memoranda and internal corporate reports. We have previously stated, as a matter of policy, that under Section 13(b)(2) "every public company needs to establish and maintain records of sufficient accuracy to meet adequately four interrelated objectives: appropriate reflection of corporate transactions and the disposition of assets; effective administration of other facets of the issuer's internal control system; preparation of its financial statements in accordance with generally accepted accounting principles; and proper auditing." Statement of Policy Regarding the Foreign Corrupt Practices Act of 1977, Release No. 34-17500 (Jan. 29, 1981) [46 FR 11544].
- [77](#) See Instruction 1 to new Item 308 of Regulations S-K and S-B, Instruction 1 to Item 15 of Form 20-F and Instruction 1 to paragraphs (b), (c), (d) and (e) of General Instruction B.6 to Form 40-F.
- [78](#) This statement should not be interpreted to mean that management personally must conduct the necessary activities to evaluate the design and test the operating effectiveness of the company's internal control over financial reporting. Activities, including those necessary to provide management with the information on which it bases its assessment, may be conducted by non-management personnel acting under the supervision of management.
- [79](#) See Statements on Standards for Attestation Engagements No. 10.
- [80](#) See Exchange Act Rules 13a-15(b) and 15d-15(b) [17 CFR 240.13a-15(b) and 240.15d-15(b)].
- [81](#) See letters regarding File No. S7-40-02 of: AICPA; Executive Responsibility; FED; and Protiviti.
- [82](#) See Protiviti letter regarding File No. S7-40-02.

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

- [83](#) See letters regarding File No. S7-40-02 of: ABA; ACB; ACCA; Association for Financial Professionals ("AFP"); Am. Bankers Assoc.; BDO; Business Roundtable ("BRT"); Computer Sciences Corporation ("CSC"); Compass; Thomas Damman ("Damman"); EEI; Emerson Electric Co. ("Emerson"); FEI; Fried, Frank, Harris, Shriver and Jacobson ("Fried Frank"); International Paper Company ("IPC"); ICBA; NYCB-CCL; New York State Bar Association ("NYSBA"); Siemens AG ("Siemens"); Software & Information Industry Association ("SIIA"); and Software Finance and Tax Executives Council ("SOFTEC").
- [84](#) See Damman letter regarding File No. S7-40-02.
- [85](#) See letters regarding File No. S7-40-02 of: ABA; ACB; ACCA; BRT; CSC; Emerson; Fried Frank; ICBA; IPC; NYCB-CCL; SIIA; and SOFTEC.
- [86](#) See letters regarding File No. S7-40-02 of: Am. Bankers Assoc.; CSC; Fried Frank.
- [87](#) See letters regarding File No. S7-40-02 of: Damman; Compass; EEI; Executive Responsibility Advisors, LLC ("Executive Responsibility"); and Siemens.
- [88](#) See letters regarding File No. S7-40-02 of: ABA and BDO.
- [89](#) See BDO letter regarding File No. S7-40-02.
- [90](#) See ABA letter regarding File No. S7-40-02.
- [91](#) See Emerson letter regarding File No. S7-40-02.
- [92](#) See Exchange Act Rules 13a-15(d) and 15d-15(d) [17 CFR 240.13a-15(d) and 240.15d-15(d)].
- [93](#) For example, where a component of internal control over financial reporting is subsumed within disclosure controls and procedures, even where systems testing of that component would clearly be required as part of the annual evaluation of internal control over financial reporting, management could make a different determination of the appropriate nature of the evaluation of that component for purposes of a quarterly evaluation of disclosure controls and procedures.
- [94](#) See Exchange Act Rules 13a-15(b) and 15d-15(b).
- [95](#) See ABA letter regarding File No. S7-40-02.
- [96](#) See Intel letter regarding File No. S7-40-02.
- [97](#) See Release No. 33-8128 (Sept. 16, 2002) [67 FR 58480]. The final rule amendments do not require that the evaluation take place on the last day of the period, but that the statement of effectiveness of the issuer's disclosure controls and internal control over financial reporting be as of the end of the period.
- [98](#) We have also made conforming changes to Forms 20-F and 40-F to clarify that the management of a foreign private issuer must disclose in the issuer's annual report filed on Form 20-F or 40-F any change in the issuer's internal control over financial reporting that occurred during the period covered by the annual report and that materially affected, or is reasonably likely to affect, this internal control. See Item 15(d) of Form 20-F and General Instruction B(6)(e) of Form 40-F.
- [99](#) See Exchange Act Rules 10b-5 and 12b-20 [17 CFR 240.10b-5 and 17 CFR 240.12b-20].
- [100](#) This is the disclosure required by paragraph 5 of the certification form.
- [101](#) 15 U.S.C. 78m(b)(2).

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

- [102](#) See Codification of Statement on Auditing Standards AU §319.18.
- [103](#) Pub. L. 102-242, 105 Stat. 2242 (1991).
- [104](#) See Section 405 of the Sarbanes-Oxley Act.
- [105](#) See Section II. J. below.
- [106](#) 12 U.S.C. 1831m.
- [107](#) The designated laws and regulations are federal laws and regulations concerning loans to insiders and federal and state laws and regulations concerning dividend restrictions. See 12 CFR Part 363, Appendix A, Guideline 12.
- [108](#) See 12 CFR 363.2, adopted in 58 FR 31332. These requirements only apply to an insured depository institution with total assets of \$500 million or more. We recognize that the FDIC's regulations use the term "internal control structure and procedures for financial reporting" rather than the term "internal control over financial reporting" used in our rules. We think the differences in the meaning of the two terms are insignificant because both Section 36(b)(2) of the Federal Deposit Insurance Act and Section 404(a) of the Sarbanes-Oxley Act refer to "internal control structure and procedures for financial reporting." Nevertheless, the FDIC has defined the term "financial reporting" to include financial statements prepared in accordance with generally accepted accounting principles ("GAAP") and those prepared for regulatory reporting purposes (see FDIC Financial Institution Letter FIL-86-94, dated December 23, 1994).
- [109](#) 12 CFR 363.3.
- [110](#) 12 CFR 363.4(a) and (b).
- [111](#) 12 CFR Part 363.
- [112](#) Services and functions are considered "comparable" if the holding company prepares and submits the management assessment of the effectiveness of the internal control structure and procedures for financial reporting and compliance with the designated safety and soundness laws and regulations based on information concerning the relevant activities and operations of those subsidiary institutions subject to Part 363. See 12 CFR Part 363, Appendix A, Guideline 4.
- [113](#) This rating is more commonly known as the CAMELS rating, which addresses Capital adequacy, Asset quality, Management, Earnings, Liquidity and Sensitivity to market risk. See 12 CFR 363.1(b)(2). The appropriate federal banking agency may determine that an insured depository institution with total assets in excess of \$9 billion that is a subsidiary of a holding company may not satisfy its FDIC internal control report requirement with an internal control report of the consolidated holding company's management if the agency determines that there could be a significant risk to the affected deposit insurance fund if the institution were allowed to satisfy its requirements in this manner. See 12 CFR 363.1(b)(3).
- [114](#) The FDIC's regulations do not specifically require that management identify the control framework used to evaluate the effectiveness of the institution's internal control over financial reporting. However, given the requirements of Sections 101 and 501 of the American Institute of Certified Public Accountants' attestation standards, the FDIC believes that the framework used must be disclosed or otherwise publicly available to all users of reports that institutions file with the FDIC pursuant to Part 363 of the FDIC's regulations.

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

- [115](#) The FDIC's regulations do require an independent public accountant to examine, attest to, and report separately on, the assertion of management concerning the institution's internal control structure and procedures for financial reporting, but these regulations do not require the accountant to be a registered public accounting firm. See 12 CFR 363.3(b).
- [116](#) Our rules do not provide an exemption that parallels the FDIC's exemption for insured depository institutions with less than \$500 million in assets. It would be incongruous to provide an exemption in our rules for small depository institutions and not other small, non-depository Exchange Act reporting companies.
- [117](#) An insured depository institution subject to both the FDIC's requirements and our new requirements choosing to file a single report to satisfy both sets of requirements will file the report with its primary federal regulator under the Exchange Act and the FDIC, its primary federal regulator (if other than the FDIC), and any appropriate state depository institution supervisor under Part 363 of the FDIC's regulations. A holding company choosing to prepare a single report to satisfy both sets of requirements will file the report with the Commission under the Exchange Act and the FDIC, the primary federal regulator of the insured depository institution subsidiary subject to the FDIC's requirements, and any appropriate state depository institution supervisor under Part 363.
- [118](#) Management will not be permitted to conclude that the registrant's internal control over financial reporting is effective if there are one or more material weaknesses in the registrant's internal control over financial reporting.
- [119](#) An insured depository institution subject to both the FDIC's requirements and our new requirements choosing to file a single management report to satisfy both sets of requirements will file the attestation report with its primary federal regulator under the Exchange Act and the FDIC, its primary federal regulator (if other than the FDIC), and any appropriate state depository institution supervisor under Part 363 of the FDIC's regulations. A holding company choosing to prepare a single management report to satisfy both sets of requirements will file the attestation report with the Commission under the Exchange Act and the FDIC, the primary federal regulator of the insured depository institution subsidiary subject to the FDIC's requirements, and any appropriate state depository institution supervisor under Part 363.
- [120](#) See Section 405 of the Sarbanes-Oxley Act ("Nothing in section 401, 402, or 404, the amendments made by those sections, or the rules of the Commission under those sections shall apply to any investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8)."). The provisions that would not extend to registered investment companies include amendments to Exchange Act rules 13a-15(c) and 15d-15(c) (requiring annual evaluation of the effectiveness of internal control over financial reporting); Exchange Act rules 13a-15(d) and 15d-15(d) (requiring quarterly evaluation of any change in internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, internal control over financial reporting); and Items 308(a) and (b) of Regulations S-K and S-B (requiring annual report by management on internal control over financial reporting and attestation report on management's evaluation of internal control over financial reporting).
- [121](#) Proposed paragraph 4 of the certification section of proposed Form N-CSR. Proposing Release, note 26 above, 67 FR at 66250. We received 7 comment letters on the proposed changes to the certification rules with respect to investment companies in the Proposing Release. See letters regarding File No. S7-40-02 of: the Investment Company Institute ("ICI"); Protiviti; OppenheimerFunds, Inc. ("Oppenheimer"); The Association of the Bar of the City of New York; Leslie Ogg of Board Services Corporation ("Ogg"); Federated Funds; and D&T.

- [122](#) See letters regarding File No. S7-40-02 of: Association of the Bar of the City of New York; ICI; and Oppenheimer.
- [123](#) See Section 302(a)(4)(A) and (B) of the Sarbanes-Oxley Act (requiring signing officers to certify that they are responsible for establishing and maintaining internal controls and have designed the internal controls to ensure that material information relating to the issuer is made known to the signing officers).
- [124](#) For a discussion of changes to the form of the Section 302 certification for operating companies, see Section III. D. below.
- [125](#) Proposed Exchange Act Rules 13a-15(c) and 15d-15(c), proposed Investment Company Act Rule 30a-2(b)(4)(iii), and proposed Investment Company Act Rule 30a-3(b).
- [126](#) See letters regarding File No. S7-40-02 of: D&T; ICI; Ogg; and Oppenheimer.
- [127](#) See Release No. IC-25914 (Jan. 27, 2003) [68 FR 5348, 5352 n. 43] (noting that in the case of a series fund or family of investment companies in which the disclosure controls and procedures for each fund in the series or family are the same, a single evaluation of the effectiveness of the disclosure controls and procedures for the series or family could be used in multiple certifications for the funds in the series or family, as long as the evaluation has been performed within 90 days of the report on Form N-CSR).
- [128](#) See, for example, the letters regarding File No. S7-40-02 of: AICPA; D&T; CSC; E&Y; and Association of the Bar of the City of New York, Committee on Securities Regulation ("NYCB-CSR").
- [129](#) See Section II. I., above, for compliance dates applicable to registered investment companies.
- [130](#) See Section V. below.
- [131](#) See letters regarding File No. S7-06-03 of: ABA; Cleary, Gottlieb, Steen & Hamilton ("Cleary"); Prof. Paul A. Griffin ("Griffin"); Intel Corporation ("Intel"); ICI; PwC; John Stalnaker and Patrick Derksen ("Stalnaker"); and Rooks Pitts ("Rooks").
- [132](#) See letters regarding File No. S7-06-03 of: ABA; Cleary; Intel; and PwC.
- [133](#) See letters File No. S7-06-03 of ABA and Cleary.
- [134](#) Id.
- [135](#) Pub. L. No. 83-406, 88 Stat. 129 (1974).
- [136](#) See letters regarding File No. S7-06-03 of: ABA; Cleary; and PwC.
- [137](#) See ABA letter regarding File No. S7-06-03.
- [138](#) Id.
- [139](#) See Stalnaker letter regarding File No. S7-06-03.
- [140](#) See 149 Cong. Rec. S5325 (daily ed. Apr. 11, 2003).
- [141](#) Id. at S5331.
- [142](#) See Release No. 33-8212 (Mar. 21, 2003) [68 FR 15600] at fn. 37.
- [143](#) See ABA letter regarding File No. S7-06-03.

- [144](#) See letters regarding File No. S7-06-03 of: ABA; Cleary; Intel; and PwC.
- [145](#) We recently adopted Form N-CSR, to be used by registered management investment companies to file certified shareholder reports with the Commission. See Release No. IC-25914 (Jan. 27, 2003) [68 FR 5348]. As adopted, Form N-CSR requires the Section 302 certifications to be filed as an exhibit to a report on Form N-CSR. Item 10(b) of Form N-CSR.
- [146](#) Accordingly, we are revising Exchange Act Rules 13a-14 and 15d-14 to delete from those rules the detailed description of the contents of the required certifications and to revise the instructions to Forms 10-Q, 10-QSB, 10-K, and 10-KSB to delete the references to the Section 302 certification requirements. We are also adopting similar changes to Investment Company Act Rule 30a-2 and Form N-CSR.
- [147](#) See General Instruction A of Form N-CSR (Form N-CSR is a combined reporting form to be used for reports of registered management investment companies under Section 30(b)(2) of the Investment Company Act and Sections 13(a) or 15(d) of the Exchange Act); n. 28 above (discussing issuers covered by Sections 13(a) and 15(d) of the Exchange Act). Registered management investment companies that are required to file reports on Form N-CSR pursuant to Section 13(a) or 15(d) of the Exchange Act will be required to provide the Section 906 certifications under Exchange Act Rules 13a-14(b) and 15d-14(b) as well as Investment Company Act Rule 30a-2(b). By contrast, registered management investment companies that are required to file reports on Form N-CSR are required to provide the Section 302 certifications solely under Investment Company Act Rule 30a-2(a), which was adopted under Sections 13(a) and 15(d) of the Exchange Act as well as the Investment Company Act. Release No. 33-8124 (Aug. 28, 2002) [67 FR 57276, 57295]; Release No. IC-25914 (Jan. 27, 2003) [68 FR 5348, 5365].
- [148](#) See also Section 3(b)(1) of the Sarbanes-Oxley Act, which provides that "[a] violation by any person of this Act . . . shall be treated for all purposes in the same manner as a violation of the Securities Exchange Act of 1934 . . . and any such person shall be subject to the same penalties, and to the same extent, as for a violation of that Act. . . ."
- [149](#) See Rule 302(b) of Regulation S-T [17 CFR 232.302(b)]. Among other things, this rule requires that an issuer maintain manually signed certifications or other authenticating documents.
- [150](#) See, for example, Item 601(b)(32)(ii) of Regulation S-K.
- [151](#) 15 U.S.C. 78r.
- [152](#) 15 U.S.C. 77k.
- [153](#) 5 U.S.C. 552 et seq.
- [154](#) See Exchange Act Rule 12b-15 [17 CFR 240.12b-15] and Investment Company Act Rule 8b-15 [17 CFR 270.8b-15]. Depending on the contents of the amendment, the form of certification required to be included may be subject to modification.
- [155](#) See Exchange Act Rules 13a-14(b) and 15d-14(b) [17 CFR 240.13a-14(b) and 240.15d-14(b)] and Investment Company Act Rule 30a-2(b) [17 CFR 270.30a-2(b)].
- [156](#) See Release No. 33-8212 (Mar. 21, 2003) [68 FR 15600] at Section III.

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

- [157](#) We are modifying that interim guidance, however, to more closely parallel the provisions of Section 302 of Regulation S-T that require retention of manual signatures for electronically filed signed statements. Issuers furnishing Section 906 certifications to the Commission as an exhibit to the periodic reports to which they relate during the period covered by the interim guidance should insert the following legend after the text of each certification: "A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form within the electronic version of this written statement required by Section 906, has been provided to [name of issuer] and will be retained by [name of issuer] and furnished to the Securities and Exchange Commission or its staff upon request."
- [158](#) Use of Exhibit 99 for this purpose will remain in effect until we announce that our EDGAR system permits registrants to file or furnish exhibits 31 and 32 for Section 302 and 906 certifications. We will issue a statement and post it on the Commission's website to announce this date as soon as it becomes known.
- [159](#) For a registered management investment company filing reports on Form N-CSR, the EDGAR document type should be EX-99.906CERT for the Section 906 certifications.
- [160](#) 44 U.S.C. 3501 et seq.
- [161](#) 44 U.S.C. 3507(d) and 5 CFR 1320.11.
- [162](#) See Rule 302 of Regulation S-T [17 CFR 232.302].
- [163](#) See Release No. 33-8138 (Oct. 22, 2002) [67 FR 66208] and Release No. 33-8212 (Mar. 21, 2003) [68 FR 15600].
- [164](#) See letters regarding File No. S7-40-02 of: AICPA; BDO; D&T; Emerson; E&Y; IPC; Intel; and NYCB-CCL.
- [165](#) See Intel letter regarding File No. S7-40-02.
- [166](#) Our estimates are based on information from with several large and small firms, accounting firms and trade and professional associations.
- [167](#) The estimates used in the releases proposing these rules were based on the number of filings that we received in fiscal year 2001.
- [168](#) We assumed the estimated burdens in the second and third years would decline by 75% from the first year estimate.
- [169](#) Our PRA estimates do not include any additional burdens or costs that a company will incur as a result of having to obtain an auditor's attestation report on management's internal control report because the PCAOB, rather than the Commission, is responsible for establishing the attestation standards and the Sarbanes-Oxley Act itself requires companies to obtain such an attestation. We have, however, included an estimated 0.5 hour burden in our revised annual burden estimates to account for the filing by the company of the attestation report.
- [170](#) The burden allocation for Forms 20-F and 40-F, however, use a 25% internal to 75% outside professional allocation to reflect the fact that foreign private issuers rely more heavily on outside professionals for the preparation of these forms.

Final Rule: Management's Reports on Internal Control Over Financial Report...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

- [171](#) While Section 906 of the Sarbanes-Oxley Act requires that certifications must accompany a periodic report, we are increasing our PRA burdens in view of the fact that the amendments explicitly require companies to furnish Section 906 certifications as exhibits to these reports. To date, companies have used various methods to fulfill their obligations under Section 906, and have not consistently submitted the certifications as part of the report.
- [172](#) Many registered management investment companies have multiple portfolios. However, they prepare separate financial statements for each portfolio. Thus, the burden of the Section 906 certifications is estimated on a portfolio basis rather than a registered management investment company basis.
- [173](#) This number represents the burden associated with the average number of portfolios per form. This number will vary for each registered management investment company depending on the number of portfolios. We estimate that the paperwork burden for each portfolio is one hour.
- [174](#) This estimate is based on the estimated total burden hours of 5,396,266, an assumed 75%/25% split of the burden hours between internal staff and external professionals, and an hourly rate of \$200 for internal staff time and \$300 for external professionals. The hourly cost estimate is based on consultations with several registrants and law firms and other persons who regularly assist registrants in preparing and filing periodic reports with the Commission. Our PRA estimate does not reflect any additional cost burdens that a company will incur as a result of having to obtain an auditor's attestation on management's internal control report.
- [175](#) This calculation is based on an estimate of burden hours multiplied by a cost of \$200.00 per hour. (117,048 hours multiplied by \$200.00 per hour). The hourly cost estimate is based on consultations with several registrants and law firms and other persons who regularly assist registrants in preparing and filing periodic reports with the Commission.
- [176](#) See ABA letter regarding File No. S7-06-03.
- [177](#) 5 U.S.C. 552 et seq.
- [178](#) 15 U.S.C. 78w(a)(2).
- [179](#) 15 U.S.C. §77b(b).
- [180](#) 15 U.S.C. 78c(f).
- [181](#) 15 U.S.C. 80a-2(c).
- [182](#) 5 U.S.C. 601.
- [183](#) 5 U.S.C. 603.
- [184](#) 17 CFR 240.0-10(a).
- [185](#) 17 CFR 270.0-10.
- [186](#) This estimate is based on figures compiled by the Commission staff regarding investment companies registered on Forms N-1A, N-2 and N-3, which are required to file reports on Form N-CSR.
- [187](#) This estimate includes the burden for one annual report and three quarterly reports.

Final Rule: Management's Reports on Internal Control Over Financial Reporting...ification of Disclosure in Exchange Act Periodic Reports; Rel. No. 33-8238

- [188](#) Under the method we used to estimate the PRA burdens associated with the Section 404 rules, we estimated that companies with less than \$100 million in revenues would be subject to an added annual reporting burden of approximately 100 hours.
- [189](#) The estimated burden for one annual report and three quarterly reports.
- [190](#) See Beasley, Carcello and Hermanson, *Fraudulent Financial Reporting: 1987-1997, An Analysis of U.S. Public Companies* (Mar. 1999) (study commissioned by the Committee of Sponsoring Organizations of the Treadway Commission).
- [191](#) 17 CFR 240.12b-2.

<http://www.sec.gov/rules/final/33-8238.htm>

[Home](#) | [Previous Page](#)

Modified: 06/11/2003

SEC Implements Internal Control Provisions of Sarbanes-Oxley Act; Adopts Investment Company R&D Safe Harbor; Press Release 2003-66



[Home](#) | [Previous Page](#)

U.S. Securities and Exchange Commission

SEC Implements Internal Control Provisions of Sarbanes-Oxley Act; Adopts Investment Company R&D Safe Harbor

FOR IMMEDIATE RELEASE 2003-66

Washington, D.C., May 27, 2003 — The Securities and Exchange Commission today voted to adopt rules concerning management's report on internal control over financial reporting and certification of disclosures in Exchange Act periodic reports. The Commission also voted to adopt new Rule 3a-8 under the Investment Company Act to provide a nonexclusive safe harbor from the definition of investment company for certain research and development companies.

Management's report on internal control over financial reporting and certification of disclosure in Exchange Act periodic reports

The Commission voted to adopt rule and form amendments to implement requirements of Section 404 of the Sarbanes-Oxley Act of 2002.

Management's Report on Internal Control over Financial Reporting

Section 404 of the Act directs the Commission to adopt rules requiring each annual report of a company, other than a registered investment company, to contain (1) a statement of management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and (2) management's assessment, as of the end of the company's most recent fiscal year, of the effectiveness of the company's internal control structure and procedures for financial reporting. Section 404 also requires the company's auditor to attest to, and report on management's assessment of the effectiveness of the company's internal controls and procedures for financial reporting in accordance with standards established by the Public Company Accounting Oversight Board. The Commission received over 60 comments on the Section 404 proposals that expressed general overall support for the Commission's approach to implementing Section 404 of the Act. The adopting release will incorporate a number of changes recommended by commenters.

Under the final rules, management's annual internal control report will have to contain:

SEC Implements Internal Control Provisions of Sarbanes-Oxley Act; Adopts Investment Company R&D Safe Harbor; Press Release 2003-66

- a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company;
- a statement identifying the framework used by management to evaluate the effectiveness of this internal control;
- management's assessment of the effectiveness of this internal control as of the end of the company's most recent fiscal year; and
- a statement that its auditor has issued an attestation report on management's assessment.

Under the new rules, management must disclose any material weakness and will be unable to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses in such control. Furthermore, the framework on which management's evaluation is based will have to be a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment.

The new rules implementing Section 404 of the Act will define the term "internal control over financial reporting" to mean

a process designed by, or under the supervision of, the registrant's principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant'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 registrant;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and receipts and expenditures of the registrant are being made only in accordance with authorizations of management and directors of the registrant; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements.

SEC Implements Internal Control Provisions of Sarbanes-Oxley Act; Adopts Investment Company R&D Safe Harbor; Press Release 2003-66

The Commission also voted to adopt amendments requiring companies to perform quarterly evaluations of changes that have materially affected or are reasonably likely to materially affect the company's internal control over financial reporting.

Compliance with the rules regarding management's report on internal controls will be required as follows: companies, other than foreign private issuers, meeting the definition of an "accelerated filer" in Exchange Act Rule 12b-2 (generally, U.S. companies that have equity market capitalization over \$75 million and have filed an annual report with the Commission) will be required to comply with the management report on internal control over financial reporting requirements for fiscal years ending on or after June 15, 2004, and all other issuers, including small business issuers and foreign private issuers, will be required to comply for their fiscal years ending on or after April 15, 2005.

Certifications

The final rules will amend the exhibit requirements for periodic reports to add the certifications required by Sections 302 and 906 of the Sarbanes-Oxley Act to the list of required exhibits to be included in reports filed with the Commission. Under the final rules, the specific form and content of the Section 302 certification will be set forth in the applicable exhibit filing requirements for a company's periodic reports.

The amendments will permit companies to "furnish" rather than "file" the Section 906 certifications with the Commission. Thus, the certifications will not be subject to liability under Section 18 of the Exchange Act. Moreover, the certifications will not be subject to automatic incorporation by reference into a company's Securities Act registration statements, which are subject to liability under Section 11 of the Securities Act, unless the issuer takes steps to include the certifications in a registration statement.

The rules and form amendments concerning Section 302 and Section 906 certifications generally will become effective sixty days after their publication in the Federal Register.

Rule 3a-8

As adopted by the Commission, new Rule 3a-8 under the Investment Company Act will modernize the test that R&D companies use in determining their status under the Act.

R&D companies tend to have few tangible assets and often hold large amounts of capital in liquid instruments so that funds are readily available for research and development activities. Some R&D companies also enter into strategic alliances that may include a strategic investment, where one R&D company purchases a non-controlling securities position in another company. As a result, an R&D company may fall within the definition of investment

SEC Implements Internal Control Provisions of Sarbanes-Oxley Act; Adopts Investment Company R&D Safe Harbor; Press Release 2003-66

company. The new rule will serve as a nonexclusive safe harbor from the definition of investment company in Section 3(a)(1) of the Act.

The analysis set forth in the new rule generally will focus on an R&D company's use of its capital and other indicia of the company's primary engagement in a non-investment business. Generally, a company will be eligible to rely on the rule's nonexclusive safe harbor if it:

- has research and development expenses that are a substantial percentage of its total expenses for its last four fiscal quarters combined and that equal at least half of its net income derived from investments in securities for that period;
- has investment-related expenses that do not exceed five percent of its total expenses for its last four fiscal quarters combined;
- makes its investments to conserve capital and liquidity until it uses the funds in its primary business subject to certain exceptions; and
- is primarily engaged, directly or through a company or companies that it controls primarily, in a noninvestment business, as evidenced by the activities of its officers, directors and employees, its public representations of policies, and its historical development.

The new rule will become effective sixty days after its publication in the *Federal Register*.

* * *

The full text of detailed releases concerning each of these items will be posted to the SEC Web site as soon as possible.

<http://www.sec.gov/news/press/2003-66.htm>

[Home](#) | [Previous Page](#)

Modified: 06/02/2003

Staff Statement on Management's Report on Internal Control Over Financial Reporting



[Home](#) | [Previous Page](#)

U.S. Securities and Exchange Commission

Division of Corporation Finance
Office of the Chief Accountant
U.S. Securities and Exchange Commission
 May 16, 2005

Staff Statement on Management's Report on Internal Control Over Financial Reporting

This statement provides the staff's views on certain issues raised in the implementation of Section 404 of the Sarbanes-Oxley Act of 2002.¹ For further information, please contact Jonathan Ingram in the Office of Chief Counsel in the Division of Corporation Finance at (202) 551-3500 or Esmeralda Rodriguez or Nancy Salisbury in the Office of the Chief Accountant at (202) 551-5300.

A. Feedback Received on the Implementation of the Internal Control Reporting Provisions

Section 404 of the Sarbanes-Oxley Act of 2002² directed the Commission to adopt rules requiring each reporting company, other than a registered investment company, to include in its annual report a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting, as well as an assessment of the effectiveness of those internal controls. Section 404, and the rules and standard promulgated relating to the Act, also specifies that each registered public accounting firm that prepares or issues an audit report on a company's annual financial statements must attest to, and report on, management's assessment of internal control over the financial reporting in accordance with standards set by the Public Company Accounting Oversight Board (PCAOB).

Accelerated filers³ were required to comply with the internal control reporting provisions for the first time in connection with their fiscal years ending on or after November 15, 2004. The Section 404 reporting requirements represent a major change for management and auditors and, during and after this initial year of implementation, the Commission has actively sought input to assess the impact of these new reporting requirements.

On April 13, 2005, the Commission hosted an all day roundtable discussion about the implementation of the internal control reporting provisions. A broad range of interested persons, including representatives of public companies (domestic and foreign), auditors, investors, members of the legal community, and the board members of the PCAOB, participated in the discussion. The Commission also invited written submissions from the public regarding

M

Staff Statement on Management's Report on Internal Control Over Financial Reporting

Section 404.⁴ The staff wishes to express its appreciation for the efforts expended by so many in providing their views and other information on this subject, which significantly contributed to the Commission's and staff's understanding of first year implementation.

The feedback made clear that companies have realized improvements to their internal controls as a result of implementing the requirements, and that the requirements have led to an improved focus on internal controls throughout the organization.⁵ However, the feedback also identified implementation areas that need further attention or clarification to reduce any unnecessary costs and other burdens without jeopardizing the benefits of the new requirements.⁶

The staff is providing this guidance to help address those areas. In general, this statement addresses the following areas:

- The purpose of internal control over financial reporting;
- Reasonable assurance, risk-based approach, and scope of testing and assessment;
- Evaluating internal control deficiencies;
- Disclosures about material weaknesses;
- Information technology issues;
- Communications with auditors; and
- Issues related to small business and foreign private issuers.

An overarching principle of this guidance is the responsibility of management to determine the form and level of controls appropriate for each organization and to scope their assessment and testing accordingly. One size does not fit all and control effectiveness is affected by many factors.

B. The Purpose of Internal Control Over Financial Reporting

An overall purpose of internal control over financial reporting is to foster the preparation of reliable financial statements. Reliable financial statements must be materially accurate. Therefore, a central purpose of the assessment of internal control over financial reporting is to identify material weaknesses that have, as indicated by their very definition, more than a remote likelihood of leading to a material misstatement in the financial statements. While identifying control deficiencies and significant deficiencies represents an important component of management's assessment, the overall focus of internal control reporting should be on those items that could result in material errors in the financial statements.⁷

Staff Statement on Management's Report on Internal Control Over Financial Reporting

The establishment and maintenance of internal accounting controls has been required of public companies since the enactment of the Foreign Corrupt Practices Act of 1977 (FCPA).⁸ The significance of Section 404 of the Act is that it re-emphasizes the important relationship between the maintenance of effective internal control over financial reporting and the preparation of reliable financial statements. Effective internal control over financial reporting can also help companies deter fraudulent financial accounting practices or detect them earlier and perhaps reduce their adverse effects. However, due to their inherent limitations, internal controls cannot prevent or detect every instance of fraud. Controls are susceptible to manipulation, especially in instances of fraud caused by the collusion of two or more people including senior management. Nonetheless, that limitation does not undercut the need for Section 404 and the improvements it has engendered and will continue to engender.

In adopting its rules implementing Section 404, the Commission expressly declined to prescribe the scope of assessment or the amount of testing and documentation required by management.⁹ The scope and process of the assessment should be reasonable, and the assessment (including testing) should be supported by a reasonable level of evidential matter. Each company should also use informed judgment in documenting and testing its controls to fit its own operations, risks and procedures. Management should use its own experience and informed judgment in designing an assessment process that fits the needs of that company.¹⁰ Management should not allow the goal and purpose of the internal control over financial reporting provisions - the production of reliable financial statements - to be overshadowed by the process.

C. Reasonable Assurance, Risk-based Approach and Scope of Testing and Assessment

In the feedback received, many questions were raised about the judgment and processes used to determine the appropriate level of identification and testing of controls necessary in order to achieve reasonable assurance regarding the reliability of the financial statements.

The Concept of Reasonable Assurance

Management is required to assess whether the company's internal control over financial reporting is effective in providing reasonable assurance regarding the reliability of financial reporting.¹¹ Management is not required by Section 404 of the Act to assess other internal controls. Further, while "reasonable assurance" is a high level of assurance, it does not mean absolute assurance. As noted earlier, internal control over financial reporting cannot prevent or detect all errors, misstatements, or fraud. Rather, the "reasonable assurance" referred to in the Commission's implementing rules relates back to similar language in the FCPA. Exchange Act Section 13(b)(7) defines "reasonable assurance" and "reasonable detail" as "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs."¹² The Commission has long held that

"reasonableness" is not an "absolute standard of exactitude for corporate records."¹³

In addition, the staff recognizes that while "reasonableness" is an objective standard, there is a range of judgments that an issuer might make as to what is "reasonable" in implementing Section 404 and the Commission's rules. Thus, the terms "reasonable," "reasonably" and "reasonableness" in the context of Section 404 implementation do not imply a single conclusion or methodology, but encompass the full range of potential conduct, conclusions or methodologies upon which an issuer may reasonably base its decisions. Different conduct, conclusions and methodologies by different issuers in a given situation do not by themselves mean that implementation by any of those issuers is unreasonable. This also suggests that registered public accounting firms should recognize that there is a zone of reasonable conduct by issuers that should be recognized as acceptable in the implementation of Section 404. While that zone is not unlimited, the staff expects that it will be rare when there is only one acceptable choice in implementing Section 404 in any given situation.

Top-Down / Risk-Based Assessments

The feedback indicated that one reason why too many controls and processes were identified, documented and tested was that in many cases neither a top-down nor a risk-based approach was effectively used. Rather, the assessment became a mechanistic, check-the-box exercise. This was not the goal of the Section 404 rules, and a better way to view the exercise emphasizes the particular risks of individual companies. Indeed, an assessment of internal control that is too formulaic and/or so detailed as to not allow for a focus on risk may not fulfill the underlying purpose of the requirements. The desired approach should devote resources to the areas of greatest risk and avoid giving all significant accounts and related controls equal attention without regard to risk.

The assessment of internal control over financial reporting will be more effective if it focuses on controls related to those processes and classes of transactions for financial statement accounts and disclosures that are most likely to have a material impact on the company's financial statements. Employing such a top-down approach requires that management apply in a reasonable manner its cumulative knowledge, experience and judgment to identify the areas of the financial statements that present significant risk that the financial statements could be materially misstated and then proceed to identify relevant controls and design appropriate procedures for documentation and testing of those controls. For instance, the application of judgment by management and the auditor will typically impact the nature, extent and timing of control testing such that the level of testing performed for a low risk account will likely be different than it will be for a high risk account. In performing these steps, management and auditors should keep the "reasonable assurance" standard in mind.

Scope of Assessment

An issue frequently cited in the comments concerned the determination of the appropriate scope of management's assessment. Many felt that overly conservative interpretations of the applicable requirements and a hesitancy by the independent auditor to use professional judgment in evaluating management's assessment resulted in many cases in too many controls being identified, documented and tested.

As previously discussed, the staff believes that management should use a top-down, risk-based approach in determining significant accounts and related significant processes and relevant assertions. The natural result of such an approach is that management would devote greater attention and resources to the areas of greater risk.

When identifying significant accounts and related significant processes in order to determine the scope of its assessment, management generally will consider both qualitative and quantitative factors. Qualitative factors include the risk associated with the various accounts and their related processes, as discussed previously. In addition to considering qualitative factors, the staff understands that management generally establishes quantitative thresholds to be used in identifying significant accounts subject to the scope of internal control testing. The use of a percentage as a minimum threshold may provide a reasonable starting point for evaluating the significance of an account or process; however, judgment, including a review of qualitative factors, must be exercised to determine if amounts above or below that threshold must be evaluated.

Once the significant accounts and their related significant processes are identified, management must focus on the controls to be tested that are relevant to those processes. We believe that some of the large numbers of controls identified for testing during the first year of implementation may, in part, represent individual steps within what may constitute a broader control. In performing future assessments, management may wish to step back from focusing on the detail to consider whether combinations of controls previously identified individually constitute the actual control that contributes to financial statement assurance. Rather than identifying, documenting, and testing each individual step involved in a broader control definition, management's focus should be on the objective of controls, and testing the effectiveness of the combination of detailed steps that meet the broader control objective. Management may determine that not every individual step comprising a control is required to be tested in order to determine that the overall control is operating effectively.

The staff also expects that through the natural learning process management will achieve efficiencies as they complete future assessments of internal control. For example, as discussed above, management's knowledge of the prior year's assessment results will impact its current year risk-based analysis of the significant accounts and the related required documentation and testing that may be necessary. Management may determine that certain controls require more extensive testing, while other controls require little testing in a given year. Additionally, in reaching its conclusion of reasonable

assurance, management may find it appropriate to adjust the nature, extent and timing of testing from year to year - in some years delving deeply into selected internal control areas while performing less extensive testing in other areas and changing that focus from year to year.

The staff believes that efficient and effective assessments depend on internal audit and other company personnel and external auditors who are "on the ground" closest to the assessment. It is at that level where the unique circumstances of any particular situation can best be evaluated. It is thus critically important that company and auditor personnel have the requisite skills, training, and judgment to make reasonable assessments. The staff believes that the ability to make such assessments in a consistent and sound manner will improve with experience and that it is the exercise of judgment which makes the audit a professional responsibility.¹⁴

Financial Periods Used to Assess Account Significance versus Periods Used to Assess Significance of a Deficiency

When management uses a top-down approach that begins with the financial statements, it will necessarily use qualitative and quantitative assessments to identify significant accounts and plan the scope of management's testing. Companies generally should determine the accounts included within their Section 404 assessment by focusing on annual and company measures rather than interim or segment measures.¹⁵ If management identifies a deficiency when it tests a control, however, at that point it must measure the significance of the deficiency by using both quarterly and annual measures, also considering segment measures where applicable.

Timing of Management's Testing

The feedback also indicated that some auditors have been unwilling to accept management's testing and other procedures performed during the year as evidence that management's assessment of the effectiveness of internal control over financial reporting is fairly stated.¹⁶ While Section 404 of the Act and the Commission's rules require that management's and auditor's reports must be "as of" year-end, this does not mean that all testing must be done within the period immediately surrounding the year-end close. In fact, we believe that effective testing and assessment may, and in most cases preferably would, be accomplished over a longer period of time. In its adopting release, the Commission expressly noted that testing may be done over a period of time.¹⁷

Management's daily interaction with its internal control system provides it with a broad array of opportunities to evaluate its controls during the year and, in many cases, to use that work as its basis, at least in part, to reasonably conclude that its controls are in place and operating effectively as of the end of its fiscal year. For example, management might determine that controls operate effectively through direct and ongoing monitoring of the operation of controls. This might be accomplished through regular management and supervisory activities, monitoring adherence to policies and

procedures, and other actions. As a result, management may be able to test a substantial number of controls at a point in time prior to its fiscal year-end, and determine through its direct and ongoing monitoring of the operation of the controls that they also function effectively as of the fiscal year-end date, without performing further detailed testing.

D. Evaluating Internal Control Deficiencies

If control deficiencies are identified, an important part of the assessment of internal control over financial reporting is the consideration of the significance of those deficiencies and whether the risk is mitigated by compensating controls. As with determining the scope of the assessment, management must exercise judgment in a reasonable manner in the evaluation of deficiencies in internal control over financial reporting, and such evaluations may appropriately consider both qualitative and quantitative analyses. Among other things, the qualitative analysis should factor in the nature of the deficiency, its cause, the relevant financial statement assertion the control was designed to support, its effect on the broader control environment and whether other compensating controls are effective.

One particular area brought to the staff's attention involved financial statement restatements due to errors. Neither Section 404 nor the Commission's implementing rules require that a material weakness in internal control over financial reporting must be found to exist in every case of restatement resulting from an error. Rather, both management and the external auditor should use their judgment in assessing the reasons why a restatement was necessary and whether the need for restatement resulted from a material weakness in controls. Such an evaluation should be based on all the facts and circumstances, including the probability of occurrence in light of the assessed effectiveness of the company's internal control, keeping in mind that internal control over financial reporting is defined as operating at the level of "reasonable assurance."

E. Disclosures about Material Weaknesses

A number of companies have reported material weaknesses in their internal control over financial reporting in this first year of implementation. When a company identifies a material weakness, and such material weakness has not been remediated prior to its fiscal year-end, it must conclude that its internal control over financial reporting is ineffective. The Commission's rule implementing Section 404 was thus intended to bring information about material weaknesses in internal control over financial reporting into public view. The staff believes that, as a result, companies should consider including in their disclosures:

- the nature of any material weakness,
- its impact on financial reporting and the control environment, and
- management's current plans, if any, for remediating the weakness.

Disclosure of the existence of a material weakness is important, but there is other information that also may be material and necessary for an overall picture that is not misleading.¹⁸ There are many different types of material weaknesses and many different factors that may be important to the assessment of the potential effect of any particular material weakness. We received feedback suggesting that some companies believe that they are not permitted to distinguish among reported material weaknesses.¹⁹ While management is required to conclude and state in its report that internal control over financial reporting is ineffective when there is one or more material weakness, companies may, and are strongly encouraged to, provide disclosure that allows investors to assess the potential impact of each particular material weakness. The disclosure will likely be more useful to investors if management differentiates the potential impact and importance to the financial statements of the identified material weaknesses, including distinguishing those material weaknesses that may have a pervasive impact on internal control over financial reporting from those material weaknesses that do not. The goal underlying all disclosure in this area is to provide increased investor information so that an investor who chooses to do so can treat the disclosure of the existence of a material weakness as the starting point for analysis rather than the only point available.

F. Information Technology Issues

Information Technology Internal Controls

The feedback revealed different views that may have developed as to the appropriate extent of required documentation and testing necessary for information technology, or IT, internal controls, particularly with respect to general IT controls (e.g. controls over program development, program changes, computer operations, and access to programs and data). While the extent of documentation and testing requires the use of judgment, the staff expects management to document and test relevant general IT controls in addition to appropriate application-level controls that are designed to ensure that financial information generated from a company's application systems can reasonably be relied upon. For purposes of the Section 404 assessment, the staff would not expect testing of general IT controls that do not pertain to financial reporting. A company's finance and IT departments should interact closely to ensure that the proper IT controls are identified.

We have also been asked whether those companies that decide to use proprietary IT frameworks²⁰ as a guide in conducting the IT portion of their overall COSO framework assessment are required to apply all of the components related to general IT controls that may be included in such frameworks. While the use of a separate, specific IT framework is not required, the staff understands that management of some companies has found certain parts of available frameworks to be useful. In establishing the scope of its IT assessment, management should apply reasonable judgment and consider how the IT systems impact internal control over financial

reporting. Because Section 404 is not a one-size-fits-all approach to assessing controls, it is not possible for us to provide a list of the exact general IT controls that should be included in an assessment for Section 404 purposes. However, the staff does not believe it necessary for purposes of Section 404 for management to assess all general IT controls, and especially not those that primarily pertain to the efficiency or effectiveness of the operations of the organization but are not relevant to financial reporting.

Information Technology System Implementations and Upgrades

We received considerable feedback regarding the impact of the Section 404 assessment on the implementation of new IT systems and upgrades to existing systems. The feedback indicated that some companies have delayed installations of new IT systems or upgrades due to time limitations for installing, testing, and remediating control deficiencies before the company's fiscal year-end.

The staff understands the importance of new IT systems and upgrades and that they are often introduced to improve internal control. Registrants should continue to make appropriate improvements in IT systems. Of course, and notwithstanding the internal control reporting requirements, companies are required to prepare reliable financial statements following the implementation of the new information systems. In that sense, the goals of Section 404 align with management's existing responsibilities when undertaking an IT conversion or implementation project.

Some of the feedback requested that management be allowed to exclude new IT systems and upgrades implemented in the later part of a fiscal year from the scope of management's assessment for that year, suggesting an analogy be made to new business acquisitions and the guidance issued by the staff in Question 3 of its Frequently Asked Questions.²¹ However, with respect to system changes, management can plan, design, and perform preliminary assessments of internal controls in advance of system implementations or upgrades. As noted elsewhere in this statement, not all testing must occur at year end. As a result, the staff does not believe it is appropriate to provide an exclusion by management of new IT systems and upgrades from the scope of its assessment of internal control over financial reporting.

G. Communications with Auditors

Feedback from both auditors and registrants revealed that one potential unintended consequence of implementing Section 404 and Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements, has been a chilling effect in the level and extent of communications between auditors and management regarding accounting and financial reporting issues. Historically, the external auditor may have provided management with advice, based on the auditor's knowledge, experience and judgment in accounting, auditing, and financial reporting matters. Since introduction of the Act and the new

auditing requirements, the staff understands that management at times has hesitated to ask auditors technical accounting, auditing, and financial reporting questions or to provide auditors with early drafts of the financial statements (which, due to their draft nature, may contain errors), because of a concern that these actions could result in the unwarranted identification of internal control deficiencies by the auditors. Additionally, the staff understands that auditors also have a heightened concern that providing management with advice might impair the auditor's independence.

The Commission's auditor independence requirements with respect to services provided by auditors are largely predicated on four basic principles.²² In addition to these four basic principles, the Commission's rules also specifically identified nine categories of prohibited services.²³ The auditor's discussing and exchanging views with management does not in itself violate the independence principles, nor does it fall into one of those nine prohibited categories of services. The staff supports a strong audit profession where a hallmark of its professionalism is to exercise sound judgment in both the audit and in ongoing dialogue with management.

The staff recognizes that questions arise in certain circumstances as to the proper application of accounting standards. Investors benefit when auditors and management engage in dialogue, including regarding new accounting standards and the appropriate accounting treatment for complex or unusual transactions. The staff believes that as long as management, and not the auditor, makes the final determination as to the accounting used, including determination of estimates and assumptions, and the auditor does not design or implement accounting policies, such auditor involvement is appropriate and is not of itself indicative of a deficiency in the registrant's internal control over financial reporting. Further, timely dialogue between management and the auditor may positively impact audit quality and the quality of financial reporting.

The staff believes that management should not be discouraged from providing its auditors with draft financial statements (including drafts that may be incomplete in certain respects). Providing draft financial statements promotes communication between the auditor and management, and all parties should recognize the draft nature of the information. In the staff's view, errors in draft financial statements in and of themselves should not be the basis for the determination by a company or an auditor of a deficiency in internal control over financial reporting. Rather, as with all cases of identifying deficiencies, management and auditors should determine whether a deficiency exists in the processes of financial statement preparation. That identification is essentially independent of whether an error exists in draft financial statements and who found it.

H. Small Business Issuers

Some have complained that the costs and burdens of assessment and reporting requirements on internal control over financial reporting may fall disproportionately on smaller businesses. The staff will continue to assess the

effects of the internal control reporting rules on smaller public companies who have not yet been required to comply with the Act's provisions. To do so, the Commission established the Securities and Exchange Commission Advisory Committee on Smaller Public Companies, which will consider, among other things, the effect of the internal control provisions on smaller public companies. Also, at the request of the Commission staff, a task force of COSO has been established to develop additional guidance on applying COSO's framework for internal control over financial reporting to smaller companies.

I. Foreign Private Issuers

The staff is also continuing to assess the effects of the internal control reporting requirements on foreign private issuers, who are not yet required to comply with Section 404, although a number have done so. Representatives of several foreign private issuers participated in the Commission's roundtable discussion, and a number of other foreign private issuers and other interested parties have provided feedback in response to the Commission's request.

J. Conclusion

The staff will continue to evaluate the implementation of Section 404. There is a desire for the sharing of best practices so that companies and auditors can benefit from the substantial learning that has taken place from the first year of implementation, and we strongly encourage those efforts. The staff desires that the benefits are achieved in a sensible and cost-effective manner. We will continue to consider whether there are other ways we can make the process more efficient and effective while preserving the benefits.²⁴

Endnotes

¹ This staff statement represents the views of the Division of Corporation Finance and the Office of the Chief Accountant. This staff statement is not a rule, regulation, or statement of the Securities and Exchange Commission. Further, the Commission has neither approved nor disapproved its content.

² 15 U.S.C. 7262.

³ The term "accelerated filer" is defined in Exchange Act Rule 12b-2.

⁴ Those submissions have been posted on the Commission's website, see <http://www.sec.gov/news/press/4-497.shtml>.

⁵ For example, refer to comment letters (File Number 4-497) of: Forest City Enterprises, Glass Lewis, J.P. Morgan & Company, Merck & Company, and

Staff Statement on Management's Report on Internal Control Over Financial Reporting

Pepsico.

⁶ For example, refer to comment letters (File Number 4-497) of: Boston Properties, Inc., Computer Sciences Corporation, Intel Corporation, Microsoft Corporation, and The Committee on Corporate Reporting of Financial Executives International. See also the transcript from the roundtable discussion - Panel 1, Panel 3, and Panel 6.

⁷ This focus on material weaknesses will, in the staff's opinion, lead to a better understanding by investors of internal control over financial reporting, as well as its inherent limitations. The staff further believes that the Commission's rules implementing Section 404, by providing for public disclosure of material weaknesses, concentrates attention on the most important internal control issues.

⁸ Title I of Pub. L. 95-213 (1977).

⁹ Instruction 1 to Item 308 of Regulation S-K provides that "The registrant must maintain evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of the registrant's internal control over financial reporting."

¹⁰ This point also is made in one of the publicly available and commonly used assessment tools - the third volume of the report by The Committee of Sponsoring Organizations of the Treadway Commission, or COSO, Internal Control - Integrated Framework: Evaluation Tools. That volume cautioned that "because facts and circumstances vary between entities and industries, evaluation methodologies and documentation will also vary. Accordingly, entities may use different evaluation tools, or use other methodologies utilizing different evaluative techniques."

¹¹ The Commission defined, in Exchange Act Rules 13a-15(f) and 15d-15(f), "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 registrant'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:

1. Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrant;
2. 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 registrant are being made only in

Staff Statement on Management's Report on Internal Control Over Financial Reporting

accordance with authorizations of management and directors of the registrant; and

3. Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements.

¹² 15 U.S.C. 78m(b)(7). The conference committee report on amendments to the FCPA also noted that the standard "does not connote an unrealistic degree of exactitude or precision. The concept of reasonableness of necessity contemplates the weighing of a number of relevant factors, including the costs of compliance." Cong. Rec. H2116 (daily ed. April 20, 1988).

¹³ Exchange Act Release No. 17500 (January 29, 1981), 46 FR 11544 (February 9, 1981).

¹⁴ In this regard, both at the roundtable and in comments, companies and their representatives raised issues regarding auditor preparedness for first-time implementation. This is the first time such work has been undertaken en masse. Comments reflected concerns including shortages of qualified resources at the auditor, consultant and preparer level; indecision by management and auditors as to acceptable levels of control documentation and testing; shifts in direction after work had commenced; pressures on companies to commit firmly to the precise timing of work because auditor resources were limited; inexperienced staff; auditors reluctant to make decisions without national office support; pressures and long hours expended by auditors and companies to complete the control evaluation work; communication difficulties between auditors and management; and auditor concern over the PCAOB inspection process impacting their decisions as to the appropriate level of documentation and testing. Comments also reflect that the initial assessments involved much catch-up in the form of deferred maintenance in documenting control systems (especially post Y2K). The staff believes that many of these concerns will subside over time as the experience base increases and as management and auditors gain confidence in the judgments they are required to make. The staff believes it is important to separate the non-recurring first time implementation issues from issues that may have a longer-term impact on the scope and quality of Section 404 work.

¹⁵ The staff acknowledges, however, there may be certain limited circumstances where the annual company results are not the most appropriate measure. For example, where a company has one or two key segments that are driving the business and are material to investors, management also may want to consider those segment measures to determine the required level of documentation and testing. As another example, there may also be limited circumstances where interim results drive the business (such as the holiday season for retailers) and are similarly of significant interest to investors.

¹⁶ See the transcript from the roundtable discussion - Panel 3.

Staff Statement on Management's Report on Internal Control Over Financial Reporting

¹⁷ "[S]ome controls operate continuously while others operate only at certain times, such as the end of the fiscal year. We believe that each company should be afforded the flexibility to design the testing of its system of internal control over financial reporting to fit its particular circumstances. The management of each company should perform assessments of the design and operation of the company's entire system of internal control over financial reporting over a period of time that is adequate for it to determine whether, as of the end of the company's fiscal year, the design and operation of the company's internal control over financial reporting are effective." Section II.C.3 to Release No. 33-8238 (June 5, 2003).

¹⁸ See Exchange Act Rule 12b-20.

¹⁹ See transcript for roundtable discussion - Panel 2.

²⁰ For example, refer to comment letters (File Number 4-497): William T. Archey, American Electronics Association; Jane Windmeier, Target; and Rod Scott, R.G. Scott & Associates, LLC which refer to CobiT (Control Objectives for Information and related Technology), one such proprietary framework developed by the IT Governance Institute and the CobiT Steering Committee in 2000.

²¹ Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports - Frequently Asked Questions (revised October 6, 2004).

²² Those principles are: (1) an auditor cannot function in the role of management, (2) an auditor cannot audit his or her own work, (3) an auditor cannot serve in an advocacy role for his or her client and (4) an auditor and audit client cannot have a relationship that creates a mutual or conflicting interest. See Preliminary Note to Rule 2-01 of Regulation S-X. These basic principles are consistent with the guidance offered in the Independence Standard Board's Interpretation 99-1, Impact on Auditor Independence of Assisting Clients in the Implementation of FAS 133 (Derivatives), which specifically addressed the topic of auditor/client communications in the context of applying the new derivatives standard. The PCAOB adopted this interpretation as part of its interim auditing standards.

²³ The categories of prohibited services include: bookkeeping or other services related to the accounting records or financial statements of the audit client; financial information system design and implementation; appraisal or valuation services, fairness opinions, or contribution-in-kind reports; actuarial services; internal audit outsourcing; management functions or human resources; broker or dealer, investment advisor, or investment banking services; legal services and expert service unrelated to the audit; and any other service that the Commission or PCAOB determines, by regulation, is impermissible. See Item 2-01(c)(4) of Regulation S-X, 17 CFR 210. 2-01(c)(4); Exchange Act Section 10A(g).

Staff Statement on Management's Report on Internal Control Over Financial Reporting

²⁴ Additionally, the staff believes that as a result of the first year Section 404 work there is now a substantial amount of data available relating to control deficiencies, material weaknesses and audit behavior, much of which would be useful to research by academics and other interested parties. To that end, the staff welcomes research on this data.

<http://www.sec.gov/info/accountants/stafficreporting.htm>

[Home](#) | [Previous Page](#)

Modified: 03/09/2005



1666 K Street, NW
 Washington, D.C. 20006
 Telephone: (202) 207-9100
 Facsimile: (202)862-8430
 www.pcaobus.org



PCAOB Release 2005-009
 May 16, 2005

_____)
 _____))
 _____))
 _____))
 POLICY STATEMENT REGARDING) PCAOB Release No. 2005-009
 IMPLEMENTATION OF AUDITING STANDARD) May 16, 2005
 NO. 2, AN AUDIT OF INTERNAL CONTROL)
 OVER FINANCIAL REPORTING PERFORMED IN)
 CONJUNCTION WITH AN AUDIT OF FINANCIAL)
 STATEMENTS)
 _____))
 _____))
 _____))
 _____))

Summary

This Policy Statement discusses some of the issues raised during the first year of auditors' implementation of the PCAOB's Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("Auditing Standard No. 2"), which implements Sections 103 and 404 of the Sarbanes-Oxley Act of 2002 (the "Act") by establishing a process for auditing public companies' internal control over financial reporting in conjunction with an audit of financial statements. Many of these issues were raised, among other occasions, at the Securities and Exchange Commission's ("SEC" or "Commission") Roundtable on Implementation of Internal Control Reporting Provisions, on April 13, 2005. While Roundtable participants generally supported the objectives of Section 404, many expressed concerns about compliance costs and offered constructive comments about how the implementation process can be improved.

This Policy Statement considers several of the auditing practices observed in the first year of implementation that may be ineffective or inefficient means of meeting the objectives of Auditing Standard No. 2. It also describes how the PCAOB intends to supervise implementation of the standard, from providing additional guidance to make audits of internal control more effective and cost-efficient to driving improvements in implementation through our inspections of registered public accounting firms.

POLICY STATEMENT

Specifically, this Policy Statement expresses the Board's view that, to properly plan and perform an effective audit under Auditing Standard No. 2, auditors should –

- **integrate their audits** of internal control with their audits of the client's financial statements, **so that evidence gathered and tests conducted in the context of either audit contribute to completion of both audits;**
- **exercise judgment to tailor their audit plans to the risks facing individual audit clients**, instead of using standardized "checklists" that may not reflect an allocation of audit work weighted toward high-risk areas (and weighted against unnecessary audit focus in low-risk areas);
- **use a top-down approach** that begins with company-level controls, to identify for further testing only those accounts and processes that are, in fact, relevant to internal control over financial reporting, and **use the risk assessment required by the standard** to eliminate from further consideration those accounts that have only a remote likelihood of containing a material misstatement;
- take advantage of the significant flexibility that the standard allows to **use the work of others;** and
- **engage in direct and timely communication with audit clients** when those clients seek auditors' views on accounting or internal control issues before those clients make their own decisions on such issues, implement internal control processes under consideration, or finalize financial reports.

Background

The Sarbanes-Oxley Act has had a profound effect on the integrity of financial reporting in U.S. capital markets. The Act has strengthened and reformed almost every aspect of the financial reporting process, from the composition and role of the audit committee to preparers' certifications of accuracy, covering the integrity of gatekeepers such as analysts, lawyers and auditors in between. Although some of these changes have been in place for some time, the participants in the financial reporting process are now implementing one of the most challenging – but also one of the most promising – provisions of the Act.



PCAOB Release 2005-009
May 16, 2005

POLICY STATEMENT

Section 404 of the Act aims to strengthen the internal controls that underpin the accuracy and reliability of a company's published financial information. That section, along with the SEC's implementing rule, requires a public company to annually report its assessment of the effectiveness of its internal control over financial reporting. The section also requires such a company to provide its auditor's attestation to, and report on, the company's assessment. Auditing Standard No. 2 governs the auditor's responsibilities under Section 404.

In the simplest terms, investors can have much more confidence in the reliability of a corporate financial statement if corporate management demonstrates that it maintains adequate internal control over the preparation of accurate financial statements. Companies have been required to have internal control over their accounting since the Congress enacted the Foreign Corrupt Practices Act in 1977. There is no doubt, however, that the Act's requirement for annual assessments, and auditor attestations to those assessments, has led to a renewed emphasis on internal control over financial reporting and significant improvements in companies' controls.

Many of the larger public companies have recently filed their first assessments of the effectiveness of their internal controls, as well as the related reports from their auditors. There is evidence that the benefits of the internal control requirements are already being realized,^{1/} and investors have expressed strong support for the goals of Section 404, including the increased transparency that the provision provides.^{2/} Section

^{1/} Seventy-nine percent of the 222 financial executives surveyed by Oversight Systems, Inc. reported that their companies have stronger internal controls after complying with Section 404. Seventy-four percent said that their companies benefited from compliance with Sarbanes-Oxley, and, of those, 33 percent said that compliance lessened the risk of financial fraud. See Oversight Systems, Inc., The 2004 Oversight Systems Financial Executive Report on Sarbanes-Oxley (December 2004).

^{2/} See, e.g., Remarks of Mark Anson, Chief Investment Officer, California Public Employees' Retirement System, Transcript of SEC Roundtable on Implementation of Internal Control Reporting Provisions (Apr. 13, 2005) ("Roundtable Tr."); Remarks of Ann Yerger, Executive Director, Council of Institutional Investors, Roundtable Tr.; Remarks of Damon Silvers, Associate General Counsel, American Federation of Labor and Congress of Industrial Organizations, Roundtable Tr.; Letter from Laurie Fiori Hacking, Executive Director, Ohio Public Employees Retirement System, to William H. Donaldson, Chairman, SEC (Mar. 1, 2005); see also Remarks of



PCAOB Release 2005-009
May 16, 2005

POLICY STATEMENT

404 has, however, proven to be an enormous challenge for those involved in its implementation. Companies have found the requirements costly and demanding, and many have questioned whether the benefits are worth the cost.

We take these concerns seriously and are committed to learning from the first year's experience implementing Section 404. As part of this effort, on April 13, 2005, we participated in the Commission's Roundtable. The Roundtable was an opportunity for us and the Commission to hear directly from issuers, auditors, and investors on the front line of the Section 404 implementation process. Many participants at the Roundtable expressed their support for Section 404's purpose. One of the most valuable aspects of the Roundtable, however, has been the constructive criticism provided by many of those currently involved in the implementation process.

The cost of Section 404 compliance was the primary concern raised at the Roundtable.^{3/} Among other reasons, commenters suggested that costs were too high because companies and their auditors did not sufficiently focus their efforts on higher risk areas of internal control over financial reporting. In addition, commenters expressed the view that auditors did not use the work of others sufficiently or fully integrate the audit of internal control with the audit of the financial statements. Some Roundtable participants also stated that auditors are often less willing than they were previously to provide guidance to clients on accounting issues for fear of compromising independence or triggering a material weakness finding.

At the conclusion of the Roundtable, the Board agreed to take several steps to promote an internal control audit process that is both effective and cost-efficient. Today, we take the first two of these steps.^{4/} First, we are separately publishing a

Gregory Jonas, Managing Director of Accounting Specialists Group, Moody's Investors Service, Roundtable Tr.

^{3/} One survey found that for 217 public companies with average revenues of \$5 billion, first year Section 404 compliance cost, on average, \$4.36 million and consumed an average of nearly 27,000 hours. See Financial Executives International, FEI Special Survey on SOX Section 404 Implementation (March 2005).

^{4/} The Board also intends to devote the agenda of the upcoming meeting of its Standing Advisory Group, scheduled for June 8 and 9, 2005, to a discussion about implementation of Auditing Standard No. 2.



PCAOB Release 2005-009
May 16, 2005

POLICY STATEMENT

series of additional staff questions and answers related to Auditing Standard No. 2.^{5/} These questions and answers further explain and clarify provisions in Auditing Standard No. 2. In particular, these questions and answers seek to correct the misimpression that certain provisions of Auditing Standard No. 2 need to be applied in a rigid manner that constrains professional judgment and prevents the conduct of an audit in a manner that is both effective and cost-efficient. Second, we are also issuing today this Policy Statement, which amplifies some of the themes in those questions and answers and articulates our policy with respect to administering Auditing Standard No. 2.

Failure to apply the concepts discussed in this Policy Statement may reflect poor audit planning and result in unnecessary cost. Indeed, although we have not performed a detailed analysis, it is sufficiently clear to us that the costs to date associated with the implementation of Section 404 have been too high. For the Section 404 process to be sustainable, these costs must be reduced in future years. Some of this excess expense is attributable to first-year, start-up costs that should not recur in future years; nevertheless, we are concerned that auditors may not sufficiently be using several features of our standard, described below, that are designed to reduce costs without sacrificing quality.

The Integrated Audit Concept

As auditing has evolved over the last century from a process of detailed examination of individual transactions and account balances into a process of testing samples, internal control over financial reporting has emerged as the foundation not only of the financial reporting process but also of the financial statement audit. Since 1941, the SEC's regulations have required auditors to consider a company's internal controls in planning an audit.^{6/} In addition, if controls had been adequately designed and were operating effectively, then longstanding auditing standards permitted the

^{5/} The Staff Questions and Answers are available on the Board's Web site, at http://www.pcaobus.org/Standards/Staff_Questions_and_Answers/index.asp.

^{6/} Amendment of Rules 2-02 and 3-07 of Regulation S-X, Accounting Series Release No. 21, 11 Fed. Reg. 10921 (Feb. 5, 1941) (amending Regulation S-X to provide that "[i]n determining the scope of the audit necessary, appropriate consideration shall be given to the adequacy of the system of internal check and control. Due weight may be given to an internal system of audit regularly maintained by means of auditors employed on the registrant's own staff.").



PCAOB Release 2005-009
May 16, 2005

POLICY STATEMENT

auditor to rely on less costly and time-consuming procedures.^{7/} Conversely, if an auditor determined that a control was inadequate in its design or operation (or elected not to test the control), then the auditor could not rely upon that control.^{8/} In this event, the auditor would take a considerably more detailed approach by relying almost exclusively on detailed tests of account balances and transactions.

Sections 103 and 404 of the Act, and Auditing Standard No. 2, changed that audit model. Today, auditors of companies subject to Section 404 must not only obtain an understanding of internal control, but they must also examine the design and operating effectiveness of internal control sufficient to render an opinion as to that effectiveness, as required by Section 103(a)(2)(A)(iii). To reap the most benefit from this examination, and to make the overall audit process as efficient as possible, we designed in Auditing Standard No. 2 an integrated audit model.

An integrated audit combines an audit of internal control over financial reporting with the audit of the financial statements, such that the objectives of the two audits are achieved simultaneously through a single coordinated process. In an integrated audit, the auditor's examination of internal control is validated by the findings in the audit of the financial statements. In addition, the auditor's findings and conclusions reached during the audit of internal control help the auditor better plan and conduct the auditing procedures designed to determine whether the financial statements are fairly presented. The two processes are mutually reinforcing. In this way, the integrated audit helps to improve the quality and integrity of both corporate controls over financial reporting and independent financial statement audits. We also believe that an integrated audit is more cost-effective than performing two distinct processes to audit internal control and the financial statements separately.

As a practical matter, integration of the two audits means that evidence gathered and tests conducted in the context of either audit contribute to completion of both audits.

^{7/} See AU Section 319.03, *Consideration of Internal Control in a Financial Statement Audit*. Effective April 16, 2003, the PCAOB adopted, on an initial, transitional basis, temporary rules that refer to pre-existing professional standards of auditing, attestation, quality control, ethics, and independence (the "interim standards"), including AU Section 319. These standards are reproduced on our Web site at http://www.pcaobus.org/Standards/Interim_Standards/index.asp.

^{8/} See AU Section 319.04, *Consideration of Internal Control in a Financial Statement Audit*.



PCAOB Release 2005-009
May 16, 2005

POLICY STATEMENT

This kind of coordination of work requires an auditor to plan and conduct his or her work with both audits in mind. Failing to integrate these audits not only wastes resources, but it also jeopardizes the quality of the overall audit and, potentially, misses key insights that could identify and uproot a budding accounting or reporting problem.^{9/}

Some auditors have acknowledged that, for a variety of reasons, they did not achieve fully integrated audits this year. As a result, audit costs may have been substantially higher than necessary. According to a recent survey commissioned by the largest U.S. accounting firms, auditors believe that the total costs of compliance with Section 404 will decline by 46 percent next year.^{10/} Among the factors cited to support this prediction was auditors' expectations that integration will be improved.^{11/} We, too, expect that auditors will better integrate their audits in the coming years. This should meaningfully affect both audit costs and audit quality.

The Importance of Professional Judgment

Auditing Standard No. 2 is no different from any other auditing standard in that it does not prescribe detailed audit programs. For as long as the profession has established auditing standards, auditors have used those standards to tailor their own audit plans, in a manner that addresses the nature and complexity of the audit client.

Many participants in the Roundtable, as well as others, have noted, however, that some auditors have in fact failed to use tailored audit plans in their first year of auditing internal control over financial reporting under Section 404 of the Act and Auditing Standard No. 2. Those auditors have instead used a one-size-fits-all audit plan driven by standardized checklists that may have little to do with the unique issues and risks of the particular client's financial reporting processes. This is a disappointing development indicative of poor training and audit planning. Not only do audit fees

^{9/} PCAOB Staff Question and Answer No. 50 issued today provides additional guidance on integrating the audit of internal control over financial reporting with the audit of the financial statements.

^{10/} See Charles River Associates, Sarbanes-Oxley Section 404 Costs and Remediation of Deficiencies: Estimates from a Sample of Fortune 1000 Companies (Apr. 2005).

^{11/} See Letter from Deloitte & Touche, Ernst & Young, KPMG, and PricewaterhouseCoopers to Jonathan G. Katz, Secretary, SEC (Apr. 11, 2005).



PCAOB Release 2005-009
May 16, 2005

POLICY STATEMENT

increase when, for example, an audit plan calls for less experienced auditors on the engagement team to devote endless hours to process-level control testing, but audit quality also decreases, because such a plan contributes little to the search for material weaknesses in internal control that could identify a financial reporting problem.

The overall objective of Auditing Standard No. 2 is for the auditor to obtain evidence that a company's control system reasonably assures that its financial statements do not contain material misstatements. To accomplish this, the auditor must not only exercise judgment to determine how to apply the standard to audit clients in different industries and of different sizes, but also exercise judgment to focus their work on areas that pose higher risks of misstatement, due either to errors or fraud. Reliance on standardized checklists that lead to a focus on controls in low-risk areas obviously fails to meet this objective.

The Top-down Approach and Role of Risk Assessment

Auditing Standard No. 2 was designed to be applied from the top down. That is, the standard focuses the auditor first on company-level controls and then on significant accounts, which lead the auditor to significant processes and, finally, individual controls at the process, transaction, or application levels. Knowledge obtained at each step guides the auditor toward the higher risk areas within the next succeeding level of controls. By approaching the task in this way, the auditor is naturally steered toward higher risk areas and away from those with less potential to have a material impact on the financials. This approach also provides a road map through the control system to ensure that the individual controls selected for testing are, in fact, relevant to internal control over financial reporting.

An auditor who chooses another approach needlessly risks adding to the audit's cost and reducing its quality. For example, starting at the bottom increases the risk that the auditor will become bogged down in testing that may ultimately prove pointless, in light of the primary objective of preventing or detecting material misstatements of the financial statements, resulting in increased and unnecessary costs.

A risk-based approach to the auditor's testing strategy can further reduce costs while increasing audit effectiveness. The auditor should consider the overall risk related to each significant account identified to determine whether he or she should alter the nature, timing, and extent of testing of the controls over that specific account. By doing so, the auditor will be able to eliminate from further consideration accounts that have only a remote likelihood of containing a material misstatement and, in any event, devote



PCAOB Release 2005-009
May 16, 2005

POLICY STATEMENT

less audit attention to areas of low risk. In addition, the auditor should look to the individual control being tested and consider the nature, frequency, and importance of that specific control in order to determine whether the testing strategy should be revised further.

Finally, the auditor should consider, as part of his or her risk assessment, the strength of the company-level controls, to determine whether the result of testing these controls will alter the nature, timing, and extent of testing. Although the auditor may not rely solely on testing company-level controls,^{12/} strong company-level controls should lead the auditor to do less work than he or she otherwise would have performed or rely to a greater degree on the work of others.

Using the Work of Others

An auditor who applies Auditing Standard No. 2 from the top down and appropriately assesses risk should naturally identify areas where use of the work of others is not only appropriate but is also the most efficient way to perform the audit. Redoing work in these areas may unnecessarily increase costs without producing a corresponding increase in audit quality. Spending auditor resources in areas in which the auditor could rely on the work of others also may cause the auditor to focus too much on low-risk controls. As discussed earlier, this could be an early warning sign of poor audit planning.

Auditing Standard No. 2 provides the auditor with considerable flexibility to use the work of others, consistent with the profession's longstanding auditing standard on using the work of internal auditors in the financial statement audit.^{13/} There is some

^{12/} See Auditing Standard No. 2, paragraph 54. PCAOB Staff Questions and Answers Nos. 38-43 issued today provide additional guidance on how to plan and perform an audit of internal control over financial reporting using both a top-down and a risk-based approach.

^{13/} See AU Section 322, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements*. This standard provides that the work of competent and objective internal auditors may affect the nature, timing and extent of the audit. Specifically, if internal auditors are competent and objective, then external auditors may rely on work performed by internal auditors in the ordinary course of their duties. For example, "for certain assertions related to less material financial statement amounts where the risk of material misstatement or the degree of subjectivity involved



PCAOB Release 2005-009
May 16, 2005

POLICY STATEMENT

concern that auditors have been reluctant to use Auditing Standard No. 2's flexibility to rely on the work of others because the standard also requires the external auditor to obtain the principal evidence supporting his or her opinion as to whether internal control is effective overall. These provisions are not in conflict. The principal evidence provision of Auditing Standard No. 2 requires the auditor to perform sufficient auditing to reach his or her own, independent opinion as to the effectiveness of a company's internal control over financial reporting. In broad terms, it prevents auditors from merely passing on to investors the judgments and opinion of others.

As one of the questions and answers issued today explains, the principal evidence requirement is "primarily qualitative."^{14/} Indeed, under Auditing Standard No. 2 the amount of work necessary to meet the principal evidence test "is not susceptible to precise measurement."^{15/}

In practical terms, this means two things. First, the auditor should perform more work directly in high-risk areas and seek to use the work of others in areas of lesser risk. Second, in evaluating whether the auditor has met the principal evidence test, the auditor should ascribe more weight to the work he or she performs in high-risk areas.^{16/}

in the evaluation of the audit evidence is low, the auditor may decide, after considering the circumstances and the results of work ... performed by internal auditors ..., that ... testing of the assertions directly by the auditor may not be necessary." See *id.* at paragraph 22. In addition, this standard also permits auditors to request direct assistance from the internal auditors, such that internal auditors will work under the direct supervision of the external auditor. See *id.* at paragraph 27. PCAOB Staff Question and Answer No. 54 issued today provides additional guidance on using the work of others. See also PCAOB Staff Question and Answer No. 36 (Nov. 22, 2004) (stating that external auditors may "use internal auditors to provide direct assistance in the audit of internal control over financial reporting").

^{14/} PCAOB Staff Question and Answer No. 54 (May 16, 2005).

^{15/} See Auditing Standard No. 2, note to paragraph 108.

^{16/} In other words, principal evidence is not meant to be assessed by simply adding up hours or numbers of controls tested in a mechanical fashion; rather, such an approach would likely detract from the standard's goal of allowing the auditor to use the work of others in an efficient and appropriate manner.



PCAOB Release 2005-009
May 16, 2005

POLICY STATEMENT

In this manner, following the risk-based principles regarding using the work of others will, in most circumstances, result in the auditor having obtained the principal evidence supporting his or her opinion.

The Auditor's Ability to Provide Advice to Audit Clients

Finally, we are concerned about a misconception that, as a result of Auditing Standard No. 2, companies may no longer look to their auditors for advice on difficult accounting and internal control issues. This misconception appears to manifest itself in two particularly problematic ways. First, we have heard at the Roundtable and elsewhere that auditors have been unwilling to provide accounting advice to their audit clients; second, auditors have apparently encouraged audit clients to finish their assessments of internal control and their financial statements before the auditor begins audit work to attest to the fairness of those assessments and financial statements. Such practices are neither necessary nor advisable.

Auditing Standard No. 2 provides that an auditor's detection of a material misstatement in financial statements is a "strong indicator" of a material weakness in internal control. In addition, longstanding rules on auditor independence prohibit the auditor from preparing a client's financial statements and from making financial reporting decisions on behalf of management.^{17/} The prospect of PCAOB inspectors examining for compliance with these independence rules seems to have led some to conclude that management and the auditor should not consult on accounting and internal control questions or that the auditor should not review draft financial statements that, because they are not finished or complete, may contain misstatements or misapplications of Generally Accepted Accounting Principles ("GAAP"). When auditors are unwilling, or believe that they are unable, to provide advice on accounting or internal control, management may be forced to retain other accounting experts, or to make accounting decisions without the benefit of access to the auditor's technical knowledge.

^{17/} See Rule 2-01(c)(4)(i) of Regulation S-X, 17 C.F.R. § 210.2-01(c)(4)(i) (stating that an auditor is not independent of an audit client if it "prepar[es] the audit client's financial statements"); Rule 2-01(c)(4)(vi) of Regulation S-X, 17 C.F.R. § 210.2-01(c)(4)(vi) (stating that an auditor is not independent of an audit client if it "perform[s] any decision-making, supervisory, or ongoing monitoring function for the audit client"); see also Meeting of PCAOB Standing Advisory Group, February 16, 2005, available on the Board's Web site <http://www.pcaobus.org>.



PCAOB Release 2005-009
May 16, 2005

POLICY STATEMENT

Nothing in Auditing Standard No. 2 requires this result. Determining when it is appropriate for the auditor to provide accounting advice requires professional judgment and common sense. Auditors may not, of course, make accounting decisions for their clients, and management may not abandon its responsibility for quality financial reporting and simply rely on auditors to catch errors. Where management makes its own informed decisions regarding how applicable accounting principles apply to its company's circumstances, however, the auditor may discuss freely with management the meaning and significance of those principles.

To help dispel confusion on this issue, our staff addressed last June the question of whether audit clients may – or should – share draft financial statements with their auditors. The answer is decidedly yes. Indeed, information-sharing on a timely basis between management and the auditor is necessary. When reviewing draft financial statements, in determining the point at which the auditor must draw the line for purposes of identifying when a deficiency exists, the auditor should be concerned primarily about instances in which the company completed its financial statements and disclosures without recognizing a potential material misstatement. If it is clear that all applicable controls have not yet operated, then a conclusion as to whether a material misstatement in draft financial statements demonstrates a control deficiency would be premature.^{18/}

Auditors may also provide audit clients technical advice on the proper application of GAAP, including offering suggestions for management's consideration to improve disclosure and financial statement quality and giving updates on recent developments with accounting standards-setters. In addition, management may provide and discuss with the auditor preliminary drafts of accounting research memos, spreadsheets, and other working papers in order to obtain the auditor's views on the assumptions and methods selected by management. Although the auditor may determine that some of these communications need to be made in writing, timely and open communication will often be best accomplished orally.

For example, a company that is contemplating a transaction may ask the auditor for assistance in determining the proper accounting for the transaction. In this situation,

^{18/} See PCAOB Staff Question and Answer No. 7 (revised July 27, 2004) (explaining that Auditing Standard No. 2 requires an auditor to judge whether, once all applicable controls have operated, the company is able to prepare financial statements that are free of material misstatements).



PCAOB Release 2005-009
May 16, 2005

POLICY STATEMENT

the auditor may provide substantial help, including explaining how applicable accounting principles apply to the transaction, offering sample journal entries, and reviewing management's preliminary conclusions. This is very different from a situation in which the auditor identifies a potential misapplication of applicable accounting principles in connection with a transaction that the auditor learns of outside of the consultation process, such as during a quarterly review, or after management has completed its financial statements and disclosures, in which case the auditor would have to consider whether management's failure to recognize the potential misapplication of applicable accounting principles constitutes a significant deficiency or material weakness.

The Board's Approach to Oversight of Implementation of Auditing Standard No. 2

We take seriously our responsibility to oversee implementation of Auditing Standard No. 2. This includes issuing additional guidance to explain or interpret the standard as necessary, as well as supervising auditors' implementation of the standard. In particular, we intend to use our upcoming inspections to evaluate how firms have conducted the first round of audits under Auditing Standard No. 2.

Our inspections should drive improvements in the effectiveness and efficiency of registered firms' audits of internal control in two ways. First, as we have described above, Auditing Standard No. 2 leaves auditors considerable flexibility to apply the standard in a manner that is appropriate to each audit. Indeed, the standard requires auditors to use professional judgment to tailor their audit plans to the specific risks facing each audit client. In our inspections, we will look for audits that suffer from poor planning and risk assessment, such as by using standardized checklists without appropriately tailoring the procedures to the circumstances or focusing the audit on areas that are unlikely to lead to the discovery of material weaknesses in internal control at the expense of adequately auditing high-risk areas. When we detect such shortcomings, we will demand improvements.

Second, we have also described above, as well as in the staff questions and answers issued today and in the past, several approaches to the audit of internal control that we believe improve both the effectiveness and the efficiency of these audits. When we review audits that do not apply the approaches described above, we will expect auditors to justify their decisions and to be able to explain how the audit plan nevertheless met the objectives of the standard.

At the Roundtable, a number of the participants focused on the role our inspections will play in shaping implementation of Auditing Standard No. 2. Some



PCAOB Release 2005-009
May 16, 2005

POLICY STATEMENT

suggested that our inspections should require auditors to reduce costs overall. Others suggested that, if our inspections are narrowly focused on technical compliance, they could have the perverse effect of promoting a checklist mentality and discouraging the use of judgment and tailored audit planning.

We intend for our inspections to do neither. By focusing on the conduct of a high-quality audit as described above, we believe our inspections will promote efficiency without the need for us to get involved in auditors' billing practices. And, by focusing on appropriate use of judgment and risk assessment, we are deliberately planning our inspections in a manner that promotes an audit of internal control that is both thoughtful and risk-focused. In other words, we do not intend to second-guess good faith audit judgments. If we believe, however, that an auditor has approached the audit in a way that is mechanistic and does not reflect the application of professional judgment to the specific risks associated with the audit client's financial reporting system, we will not hesitate to demand changes to the auditor's approach to implementing Auditing Standard No. 2.

Conclusion

The first year's implementation of Section 404 required a tremendous effort on the part of management and auditors, as well as the commitment of substantial corporate resources. The lessons learned so far – and to be learned as we complete our first cycle of inspections of audits under Auditing Standard No. 2 – should provide a solid basis for substantial improvement in the process, including significant cost reduction in the future.



1666 K Street, N.W.
 Washington, DC 20006
 Telephone: (202) 207-9100
 Facsimile: (202) 862-8430
 www.pcaobus.org



Auditing Standard No. 2 – Internal Control
 May 16, 2005

STAFF QUESTIONS AND ANSWERS

AUDITING INTERNAL CONTROL OVER FINANCIAL REPORTING

May 16, 2005

Summary: Staff questions and answers set forth the staff's opinions on issues related to the implementation of the standards of the Public Company Accounting Oversight Board ("PCAOB" or "Board"). The staff publishes questions and answers to help auditors implement, and the Board's staff administer, the Board's standards. The statements contained in the staff questions and answers are not rules of the Board, nor have they been approved by the Board.

The following staff questions and answers related to PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* ("Auditing Standard No. 2"), were prepared by the Office of the Chief Auditor. The staff questions and answers related to Auditing Standard No. 2 are numbered sequentially upon issuance. Staff questions and answers numbered 1-37 are available on the Board's Web site at <http://www.pcaobus.org>. Additional questions should be directed to Laura Phillips, Associate Chief Auditor (202/207-9111; phillipsl@pcaobus.org) or Sharon Virag, Assistant Chief Auditor (202/207-9164; virags@pcaobus.org).

* * *

General

Q38. What is a "top-down approach" to the audit of internal control over financial reporting, and what are its benefits?

A38. In a top-down approach to auditing internal control over financial reporting, the auditor performs procedures to obtain the necessary understanding of

STAFF QUESTIONS & ANSWERS

internal control over financial reporting and to identify the controls to test in a sequential manner, starting with company-level controls and then driving down to significant accounts, significant processes, and, finally, individual controls at the process, transaction, or application levels. Auditing Standard No. 2 was designed to encourage the auditor to take this type of top-down approach to his or her audit. A top-down approach prevents the auditor from spending unnecessary time and effort understanding a process or control that does not affect the likelihood that the company's financial statements could be materially misstated.

By following the top-down sequence summarized below, the auditor focuses early in the process on matters, such as company-level controls, that can have an effect on the auditor's later decisions about scope and testing strategy. This approach also helps the auditor to identify and eliminate from further consideration accounts, disclosures, and assertions that have only a remote likelihood of containing misstatements that could cause the financial statements to be materially misstated.

Top-down Approach Sequence	Auditing Standard No. 2 Direction
Identify, understand, and evaluate the design effectiveness of company-level controls	Paragraphs 52 through 59
Identify significant accounts, beginning at the financial-statement or disclosure level	Paragraphs 60 through 67
Identify the assertions relevant to each significant account	Paragraphs 68 through 70
Identify significant processes and major classes of transactions	Paragraphs 71 through 78



Auditing Standard No. 2 – Internal Control
May 16, 2005

STAFF QUESTIONS & ANSWERS

Top-down Approach Sequence	Auditing Standard No. 2 Direction
Identify the points at which errors or fraud could occur in the process	This identification occurs during the identification of significant accounts, relevant assertions, and significant processes, and is confirmed by performing walkthroughs as described in paragraphs 79-82
Identify controls to test that prevent or detect errors or fraud on a timely basis	Paragraphs 83 through 87
Clearly link individual controls with the significant accounts and assertions to which they relate	Paragraph 84

In this top-down approach, the auditor begins by identifying, understanding, and evaluating the design of company-level controls. Company-level controls include:

- controls within the control environment, such as tone at the top, organizational structure, commitment to competence, human resource policies and procedures;
- management's risk assessment process;
- centralized processing and controls, such as shared service environments;
- controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs; and
- the period-end financial reporting process.



Auditing Standard No. 2 – Internal Control
May 16, 2005

STAFF QUESTIONS & ANSWERS

Company-level controls function within all five COSO^{1/} internal control components and often have a pervasive effect on controls at the process, transaction, or application level. Because of the pervasive effect of company-level controls, in this top-down approach, the auditor tests and evaluates the effectiveness of company-level controls first, because the results of this work will affect the auditor's testing strategy for controls at the process, transaction, and application levels. Staff Question No. 43 further discusses the role of company-level controls in the auditor's decisions about the nature, timing, and extent of tests of controls at the process, transaction, or application levels.

This top-down approach is both effective and efficient. In terms of effectiveness, the identification of significant accounts at the financial statement level (the "top") is driving the audit process "down" to the individual control level. In this manner, the auditor is assured of identifying controls to test that address relevant assertions for significant accounts. In terms of efficiency, this process prevents the auditor from spending unnecessary time and effort understanding a process or control that ultimately is not relevant to whether the financial statements could be materially misstated.

Q39. Auditors generally employ a "risk-based" approach to auditing financial statements. The auditor's assessment of the risk that a financial statement amount or disclosure is misstated affects the nature, timing, and extent of the auditor's work on that financial statement amount or disclosure. How is an audit of internal control over financial reporting risk-based?

A39. Risk assessment underlies the entire audit process described by Auditing Standard No. 2. A direct relationship exists between the degree of risk that a material weakness could exist in a particular area of the company's controls and the amount of audit attention the auditor should devote to that area. Accordingly, the lower the risk that a material weakness could exist in a particular area, the less audit attention the auditor would need to devote to the area. On the other hand, the higher the risk that a material weakness could exist in a particular area,

^{1/}

COSO refers to The Committee of Sponsoring Organizations ("COSO") of the Treadway Commission's publication, *Internal Control – Integrated Framework* (the "COSO Report"). Paragraph 49 of Auditing Standard No. 2 and the COSO report describe these components.



Auditing Standard No. 2 – Internal Control
May 16, 2005

STAFF QUESTIONS & ANSWERS

the greater the amount of audit attention the auditor should devote to the area. This relationship between risk and amount of audit attention is consistent with the auditor's responsibility to plan and perform the audit of internal control over financial reporting so that the risk that he or she fails to find a material weakness that does exist is appropriately low.

Q40. How does the auditor's assessment of the risk of financial statement misstatement affect the work that must be performed in an audit of internal control over financial reporting?

A40. The auditor's assessment of the risk that the financial statements could be materially misstated is an integral part of an audit of internal control over financial reporting conducted pursuant to Auditing Standard No. 2. The auditor's risk assessment, therefore, has a pervasive effect on the amount of work the auditor must perform.

The effects of the auditor's risk assessment are particularly significant in four provisions of Auditing Standard No. 2 that are at the center of an audit of internal control: (1) the identification of significant accounts, (2) the identification of relevant assertions, (3) the nature, timing, and extent of the auditor's tests of controls, and (4) the auditor's use of the work of others.

Significant accounts.

Paragraph 65 of Auditing Standard No. 2 describes quantitative and qualitative risk factors that the auditor should evaluate in deciding whether an account is significant. Using these risk factors, the auditor may eliminate from further consideration (unless the auditor later identifies indications of a higher level of risk) those accounts and disclosures that have only a remote likelihood of containing misstatements that could cause the financial statements to be materially misstated.

Staff Question No. 41 further discusses the identification of significant accounts.

Relevant assertions.

The auditor identifies relevant assertions related to significant accounts by evaluating the risk that the assertions could be misstated. An assertion that does not present a meaningful risk of potential material misstatement should not be



Auditing Standard No. 2 – Internal Control
May 16, 2005

STAFF QUESTIONS & ANSWERS

identified as a relevant assertion and does not need to be subject to the auditor's testing.

Nature, timing, and extent of tests of controls.

Auditing Standard No. 2 provides the auditor with the ability to test a control less extensively and farther from the "as-of" date when less risk is associated with the control. Likewise, these provisions direct the auditor to test a control more extensively and closer to the as-of date of management's assessment when more risk is associated with the control.

Staff Question No. 43 further discusses the role of an assessment of risk on the nature, timing, and extent of tests of controls.

Using the work of others.

An important component of the framework for using the work of others in an audit of internal control over financial reporting relates to the nature of the controls subjected to the work of others. Paragraph 112 of Auditing Standard No. 2 describes several risk factors that the auditor should evaluate when evaluating the nature of the controls subjected to the work of others. As these factors decrease in significance, the need for the auditor to perform his or her own work on those controls decreases. As these factors increase in significance, the need for the auditor to perform his or her own work on those controls increases. In this manner, the auditor's degree of reliance on the work of others should be naturally responsive to the degree of risk associated with the testing of those controls.

Staff Question No. 54 further discusses the role of risk assessment on the auditor's use of the work of others.

Scope and Extent of Testing

Q41. The identification of significant accounts plays a central role in the scoping of an audit of internal control over financial reporting. What role do qualitative factors and an assessment of risk have in the identification of significant accounts?

A41. As discussed in Staff Question No. 40, the auditor should determine that an account is significant based on an assessment of the risk that the account could contain misstatements that individually, or when aggregated with others,



Auditing Standard No. 2 – Internal Control
May 16, 2005

STAFF QUESTIONS & ANSWERS

could have a material effect on the financial statements. Paragraph 65 of Auditing Standard No. 2 describes quantitative and qualitative factors that the auditor should evaluate together to determine whether an account is significant. It is important for the auditor to take into account the total mix of information that is available in determining whether an account is significant. Accordingly, quantitative measures alone are not determinative of whether an account should be identified as significant.

For example, paragraph 66 of Auditing Standard No. 2 should not be understood to require that the fixed asset account be identified as a significant account for the audit of internal control over financial reporting simply because it is quantitatively large and without regard to the risk that the account could be materially misstated. The example in paragraph 66 in which the fixed asset account is determined to be significant is based on considering both quantitative and qualitative factors.

If the auditor determines that an account is a significant account for the audit of internal control over financial reporting, the auditor should design his or her control testing strategy to be responsive to his or her assessment of the risk related to the account. Staff Question No. 43 further discusses how the auditor may reduce the extent of his or her control testing for accounts that are assessed as having lower risk.

The auditor also should consider that components of an account balance may be subject to differing risks or different controls. Accordingly, the auditor may be able to reduce or eliminate testing of controls for some components. To take an obvious example, the petty cash component of the financial statement line item "cash and cash equivalents" rarely presents a more than remote risk that the financial statements could be materially misstated.

Q42. At many companies, management identifies and tests what it describes as "key" or "significant" controls as a part of its assessment of internal control over financial reporting. Is the auditor required to test all the controls that management tested because management described them as key or significant?

A42. No. Auditing Standard No. 2 does not define key or significant controls. Depending on the way in which key or significant controls are identified, testing



Auditing Standard No. 2 – Internal Control
May 16, 2005

STAFF QUESTIONS & ANSWERS

all of those controls might result in the auditor testing either more or fewer controls than necessary. Rather, paragraph 83 of Auditing Standard No. 2 states that the auditor should obtain evidence about the effectiveness of controls (either by performing tests of controls himself or herself, or by using the work of others) for all relevant assertions related to all significant accounts and disclosures in the financial statements. This direction encourages the auditor to focus on assertions that are relevant to the accounts and disclosures that the auditor has determined are significant before deciding which controls to test. This process is consistent with the top-down approach described in Staff Question No. 38.

There may be circumstances in which management identifies and tests more controls than necessary for the purpose of its assessment of internal control over financial reporting. Such a decision on the part of management should not affect the scope of the auditor's work. The auditor need test only those controls that the auditor identifies as controls over relevant assertions related to significant accounts. This direction applies to the auditor's tests of design effectiveness as well as operating effectiveness of controls.

Staff Question No. 49 further discusses the independent nature of management's decisions regarding controls to test compared with the auditor's decisions related to the testing of controls.

Q43. How does the auditor's assessment of risk affect the auditor's decisions about the nature, timing, and extent of testing of controls?

A43. As discussed further in Staff Question No. 40, a direct relationship exists between the degree of risk that a material weakness could exist in a particular area of a company's controls and the amount of audit attention the auditor should devote to that area. Accordingly, the provisions of Auditing Standard No. 2 discussed below provide the auditor with the ability to reduce his or her testing for lower-risk areas.

Nature.

As the risk associated with the control being tested decreases, the persuasiveness of the evidence that the auditor needs to obtain also decreases. On the other hand, as the risk associated with the control being tested increases,



Auditing Standard No. 2 – Internal Control
May 16, 2005

STAFF QUESTIONS & ANSWERS

the persuasiveness of the evidence that the auditor needs to obtain also increases.

Paragraphs 89 and 93 of Auditing Standard No. 2 describe the nature of the procedures the auditor might choose to perform to test the effectiveness of a control. These procedures include inquiry, observation, inspection of relevant documentation, and reperformance of the application of the control. The auditor also may perform walkthroughs, which ordinarily consist of some combination of these types of procedures, as tests of design and operating effectiveness. These procedures are listed in the order of the general level of persuasiveness of the evidence that they ordinarily would produce, from lowest to highest. Although inquiry alone is not sufficient, the auditor has significant latitude to determine what work should be done.

Timing.

Generally, as the risk associated with the control being tested decreases, the testing may be performed farther from the as-of date; on the other hand, as the risk associated with the control increases, the testing should be performed closer to the as-of date. Paragraphs 100 and 101 of Auditing Standard No. 2 describe factors that the auditor should evaluate when determining the timing of his or her testing.

In determining that the testing of a control should be performed closer to the as-of date because of increased risk associated with the control, the auditor still may test those controls as of an interim date and correspondingly adjust the nature and extent of his or her roll-forward procedures to be more extensive.

Staff Question No. 51 further discusses determining adequate roll-forward procedures.

Also, as described in paragraph 101 of Auditing Standard No. 2, the auditor should balance performing tests of controls closer to the as-of date with the need to obtain sufficient evidence of operating effectiveness. For example, if the auditor determined that he or she should test 25 operations of a control that operated multiple times per day, the auditor should not test that control 25 times on the last day of the company's fiscal year.



Auditing Standard No. 2 – Internal Control
May 16, 2005

STAFF QUESTIONS & ANSWERS

Extent.

As the risk associated with a control decreases, the extensiveness of the auditor's testing should decrease; as the risk associated with a control increases, the extensiveness of the auditor's testing also should increase. Paragraph 105 of Auditing Standard No. 2 describes three primary factors that the auditor should evaluate when determining the extent of testing the auditor should perform on a given control: (1) the nature of the control, (2) the frequency of operation, and (3) the importance of the control. Evaluating the nature of the control, and especially the importance of the control, is related directly to the auditor's assessment of risk associated with the control.

Company-level controls.

As described in Staff Question No. 38 regarding the top-down approach, the auditor's evaluation of company-level controls also will affect the auditor's decisions regarding the nature, timing, and extent of testing a control. Because company-level controls have a bearing on the auditor's evaluation of risk associated with the controls operating at more detailed levels than the company-level controls, the auditor's evaluation of company-level controls can result in increasing or decreasing the testing that the auditor otherwise would have performed on controls at the process, transaction, or application levels. Although testing company-level controls alone is not sufficient, pervasive company-level controls can have a significant effect on the auditor's testing of other controls, particularly when strong company-level controls that have a direct relationship with lower-level controls result in the auditor decreasing the testing he or she otherwise would have performed.

Q44. The Background and Basis for Conclusions of Auditing Standard No. 2 indicates that the requirements in Auditing Standard No. 2 reflect the Board's decision that "each year's audit must stand on its own." Does this mean that the auditor must ignore the results of the previous year's audit of internal control over financial reporting and conduct subsequent audits as though they were an initial audit?

A44. No. The statement that each year's audit must stand on its own does not mean that audit knowledge obtained in prior years should be ignored in subsequent years' audits. Importantly, the auditor should use previous knowledge about the company's internal control over financial reporting to inform his or her assessments of risk in the current-year's audit. For example, during



Auditing Standard No. 2 – Internal Control
May 16, 2005

STAFF QUESTIONS & ANSWERS

the first audit of internal control over financial reporting, the auditor might have determined his or her sample size for testing a control by planning for several exceptions — a sampling strategy that would have resulted in a larger sample size than if no exceptions were expected. Based on favorable audit results, the auditor might reduce his or her sample size to reflect the expectation of no exceptions in the next year.

Staff Question Nos. 39, 40, and 43 further discuss how the auditor's assessment of risk could affect his or her audit approach.

Also, as described in paragraph E120 of Auditing Standard No. 2, some natural efficiency will emerge as the auditor repeats the audit process. For example, the auditor likely will spend less time obtaining the requisite understanding of the company's internal control over financial reporting in subsequent years compared with the time that was necessary in the first year. This use of previous knowledge also means that the auditor's evaluation of the design effectiveness of controls in subsequent years should be substantially more efficient.

Additionally, the statement that each year's audit must stand on its own accommodates both benchmarking automated application controls (See Staff Question No. 45) and alternating tests of controls (See Staff Question No. 46).

Q45. Since each year's audit must stand on its own, can a benchmarking strategy for testing automated application controls be employed? How would the auditor properly execute such a testing strategy?

A45. Yes, a benchmarking strategy for testing automated application controls can be used and presents an area of potential audit efficiency for those companies that have made investments in effective Information Technology ("IT") general controls. As such, paragraph E122 of Auditing Standard No. 2 specifically acknowledges benchmarking as a testing strategy that is permitted by the standard.

In general, to render an opinion as of the date of management's assessment, the auditor needs to test controls every year. This type of evidence is needed regardless of whether controls were found to be effective at the time of the prior annual assessments or whether those controls have changed since that time



Auditing Standard No. 2 – Internal Control
May 16, 2005

STAFF QUESTIONS & ANSWERS

because even if nothing significant changed about the company — the business model, employees, organizational structure, etc. — controls that were effective last year may not be effective this year due to error, complacency, distraction, and other human conditions that result in the inherent limitations in internal control over financial reporting. Automated application controls, however, will continue to perform a given control (for example, aging of accounts receivable, extending prices on invoices, performing edit checks) in exactly the same manner until the program is changed. Entirely automated application controls, therefore, are generally not subject to breakdowns due to human failure and this feature allows the auditor to "benchmark," or "baseline," these controls.

If general controls over program changes, access to programs, and computer operations are effective and continue to be tested, and if the auditor verifies that the automated application control has not changed since the auditor last tested the application control, the auditor may conclude that the automated application control continues to be effective without repeating the prior year's specific tests of the operation of the automated application control. The nature and extent of the evidence that the auditor should obtain to verify that the control has not changed may vary depending on the circumstances, including depending on the strength of the company's program change controls.

When using a benchmarking strategy for a particular control, the auditor also should consider the importance of the effect of related files, tables, data, and parameters on the consistent and effective functioning of the automated application control. For example, an automated application for calculating interest income might be dependent on the continued integrity of a rate table used by the automated calculation.

To determine whether to use a benchmarking strategy, the auditor should evaluate the following factors. As these factors increase in significance, the control being evaluated should be viewed as well suited for benchmarking. As these factors decrease in significance, the control being evaluated should be viewed as less suited for benchmarking. These factors are:

- the extent to which the application control can be matched to a defined program within an application;



Auditing Standard No. 2 – Internal Control
May 16, 2005

STAFF QUESTIONS & ANSWERS

- the extent to which the application is stable (i.e., there are few changes from period to period); and
- whether a report of the compilation dates of all programs placed in production is available and is reliable. (This information may be used as evidence that controls within the program have not changed.)

Benchmarking automated application controls can be especially effective for companies using purchased software when the possibility of program changes is remote — for example, when the vendor does not allow access or modification to the source code.

At some point, the benchmark of an automated application control should be reestablished. To determine whether to reestablish a benchmark, the auditor should evaluate the following factors:

- the effectiveness of the IT control environment, including controls over application and system software acquisition and maintenance, access controls and computer operations;
- the auditor's understanding of the effects of changes, if any, on the specific programs that contain the controls;
- the nature and timing of other related tests; and
- the consequences of errors associated with the application control that was benchmarked.

Q46. In the context of an audit of internal control over financial reporting, what does "alternating tests of controls" mean?

A46. Alternating tests of controls relates to using the work of others and other variations in testing from year to year. The statement that each year's audit must stand on its own is a guiding principle, and one that permits significant flexibility in varying the nature, timing, and extent of work in particular areas from year to year.



Auditing Standard No. 2 – Internal Control
May 16, 2005

STAFF QUESTIONS & ANSWERS

The auditor may use the work of others in a particular area to a large extent, perhaps entirely, in one or more years and to a lesser extent in other years. This decision to use the work of others as the entirety of the audit evidence for a given area would be made using the principles described in paragraphs 108 through 125 of Auditing Standard No. 2, including evaluating the nature of the controls being tested and the competence and objectivity of the individuals who performed the work.

Variation in the auditor's testing, as paragraph 104 of Auditing Standard No. 2 explains, includes the concept that the auditor "should vary from year to year the nature, timing, and extent of testing of controls to introduce unpredictability into the testing and respond to changes in circumstances." In a particular area, from year to year, the auditor may vary the time period over which controls are tested, the number and types of procedures performed, or the combination of procedures used. Each year's audit must stand on its own, but each year's audit does not have to include the same scope of testing.

Q47. As companies refine their approach to complying with the reporting requirements of Section 404 in subsequent years, many companies are expected both to improve their processes and procedures for monitoring the operation of controls and to make further use of control self-assessments. Management also plays a role as part of internal control itself. How should these factors affect the auditor's evaluation of management's assessment?

A47. Management's daily interaction with the system of internal control provides it with a broader array of procedures to achieve reasonable assurance for its assessment of internal control over financial reporting than the auditor has available. The auditor should recognize this difference when evaluating the adequacy of management's assessment.

Paragraph 40 of Auditing Standard No. 2, which addresses the auditor's evaluation of management's assessment process, recognizes the important difference between management's assessment and the auditor's testing. The fifth bullet of that paragraph cites as examples of procedures that management could use to obtain sufficient evidence of the operating effectiveness of controls "inspection of evidence of the application of controls, or testing by means of a self-assessment process, some of which might occur as part of management's



Auditing Standard No. 2 – Internal Control
May 16, 2005

STAFF QUESTIONS & ANSWERS

ongoing monitoring activities." For example, management might be able to determine that controls operate effectively through its direct and ongoing monitoring of the operation of controls. This determination might be accomplished through performing regular management and supervisory activities, monitoring adherence to policies and procedures, and performing other routine actions. For instance, a supervisor's review of a monthly account reconciliation prepared by one of his or her subordinates could be a monitoring control that also provides management with evidence supporting its assessment of internal control over financial reporting, if the results of the supervisor's review were evaluated and documented as part of management's assessment. To appropriately evaluate the adequacy of management's assessment as directed by the standard, the auditor needs to recognize these other types of procedures that are available to management as part of the basis for its assessment.

Q48. Paragraph 126 of Auditing Standard No. 2 states that the auditor should not use management "self-assessment" of controls as part of the auditor's evidence supporting his or her opinion. Does this mean that the auditor cannot use any procedures that are labeled or characterized as a self-assessment?

A48. No. Simply labeling management tests as self-assessment does not preclude the auditor from using that work. Self-assessment, as the term is currently used by issuers and auditors, has become a broad term that refers to different types of procedures performed by various parties. Accordingly, the auditor should evaluate the nature of the self-assessment process used by management when considering whether to use this work.

Although it does not provide an explicit definition of the term self-assessment, paragraph 126 of Auditing Standard No. 2 uses the term in a specific and narrow way to mean an assessment made by the same personnel who are responsible for performing the control. The auditor should not use this type of self-assessment as a basis for the auditor's opinion because this type of work lacks sufficient objectivity for the auditor's purposes. On the other hand, the broader set of procedures that some issuers and auditors currently label as self-assessment includes assessments and tests of controls performed by persons who are members of management but are not the same personnel who are responsible for performing the control. In this manner, an assessment may be



Auditing Standard No. 2 – Internal Control
May 16, 2005

STAFF QUESTIONS & ANSWERS

carried out with varying degrees of objectivity, depending on how far the person performing the assessment is removed from the person performing the control.

When the self-assessment is being performed by persons who are members of management but are not the same personnel who are responsible for performing the control, the auditor should evaluate this work using the provisions in Auditing Standard No. 2 for using the work of others — evaluating the nature of the controls subjected to the work of others and the competence and objectivity of the individuals who performed the work. In this circumstance, the decision about whether the auditor may use the work labeled as a self-assessment, and the extent to which the auditor uses that work, involve judgment in the circumstances beyond simply whether the work is labeled self-assessment.

Q49. Should the auditor evaluate the adequacy of management's assessment of internal control over financial reporting by determining whether, on a control-by-control level, management's testing was at least as extensive as the auditor's?

A49. No. The auditor should not evaluate the adequacy of management's assessment by simply comparing, on a control-by-control level, whether management's testing was at least as extensive as the auditor's. The nature and extent of the procedures that management uses to support its assessment should be determined by management, independent of the auditor's decisions about the nature, timing, and extent of the auditor's procedures. The procedures that management performs to support its assessment might be different from the auditor's procedures, yet still provide management with an adequate basis for its assessment, for several reasons.

First, as discussed in Staff Question No. 47, management has a broader array of procedures available to support its assessment than the auditor. As discussed further in Staff Question No. 48, management also may use self-assessment in particular areas to support its overall assessment of internal control over financial reporting. In this circumstance, the auditor should evaluate whether management's overall assessment process includes periodic, objective validation of the effectiveness of self-assessments in individual areas, such as testing by internal auditors, to verify the effectiveness of self-assessments. This type of validation of self-assessments need not occur every period for every area in which a self-assessment is performed. Management's overall assessment



Auditing Standard No. 2 – Internal Control
May 16, 2005

STAFF QUESTIONS & ANSWERS

process, however, should include a rational approach for determining how frequently and extensively to verify the effectiveness of self-assessments.

The work that management performs in connection with its assessment can have a significant effect on the nature, timing, and extent of the work of the auditor. The more extensive and reliable management's assessment is, the less extensive and costly the auditor's work will need to be.

Q50. The auditor's opinion on the effectiveness of internal control over financial reporting is rendered as of a point in time (*i.e.*, at year-end), whereas the auditor's opinion on the financial statements covers the financial results over a period of time (*i.e.*, for the entire year). In an integrated audit of internal control over financial reporting and the financial statements, how should the auditor generally structure his or her testing of controls — throughout the entire period under audit or compressed toward year-end?

A50. In most circumstances, testing controls throughout the year will provide several benefits, perhaps the most important of which will be to fully integrate the audit of internal control over financial reporting with the audit of the financial statements.

In an integrated audit of internal control over financial reporting and the financial statements, the auditor ordinarily would design his or her testing of controls to accomplish the objectives of both audits simultaneously: (1) to obtain sufficient evidence to support his or her opinion on internal control over financial reporting as of year-end, and (2) to obtain sufficient evidence to support a control risk assessment of low for purposes of the audit of financial statements. By obtaining sufficient evidence to support a control risk assessment of low for purposes of the financial statement audit, the auditor will be able to reduce the amount of audit work that otherwise would have been necessary to opine on the financial statements.

To further promote an integrated approach to the audit of internal control over financial reporting and the audit of the financial statements (and, therefore, testing controls over a period of time), paragraph 160 of Auditing Standard No. 2 directs the auditor to document the reasons for assessing control risk as other



Auditing Standard No. 2 – Internal Control
May 16, 2005

STAFF QUESTIONS & ANSWERS

than low for any relevant assertions related to significant accounts. This documentation requirement reflects the expectation that the benefits associated with an integrated audit ordinarily will best be achieved by the auditor testing controls over a period of time. There may be circumstances in which it is appropriate and efficient, however, for the auditor not to test controls throughout the period and, therefore, not to assess control risk in the audit of the financial statements as low, such as when a material weakness is eliminated late in the year.

Q51. If the auditor performs procedures to test the effectiveness of controls as of an interim date, how should the auditor determine the nature and extent of roll-forward procedures that are necessary to support the auditor's opinion as of year-end?

A51. The auditor should evaluate the factors described in paragraph 100 of Auditing Standard No. 2 when evaluating the nature and extent of procedures to perform to update the results of his or her testing from an interim date to the company's year-end. As these factors decrease in significance, the evidence that needs to be obtained can be less persuasive, and the necessary updating procedures, accordingly, become less extensive. As these factors increase in significance, the necessary updating procedures become more extensive. These factors include:

- *The specific controls tested prior to the as-of date and the results of those tests.* This factor takes into consideration the nature of the control and the risks associated with the control. The lower the overall risk associated with a given control, the less extensive the auditor's updating procedures should be. Controls tested as of an interim date and for which testing exceptions were identified are an example of controls considered to be of higher risk if the auditor expects to conclude that those controls were effective as of year-end. This factor also includes the direction in paragraph 101 of Auditing Standard No. 2 that, for controls over significant non-routine transactions, controls over accounts or processes with a high degree of subjectivity or judgment in measurement, or controls over the recording of period-end adjustments (all areas of higher risk), the auditor should perform tests of controls closer to or at the as-of date rather than at an interim date.



Auditing Standard No. 2 – Internal Control
May 16, 2005

STAFF QUESTIONS & ANSWERS

- *The degree to which evidence about the operating effectiveness of those controls was obtained.* The more persuasive the evidence obtained as of an interim date, the less extensive should be the updating procedures. On the other hand, the less persuasive the evidence obtained as of an interim date is, the more extensive the updating procedures need to be.
- *The length of the remaining period.* The updating procedures should be less extensive if the updating period of time is shorter. In other words, the updating procedures for a control tested through October would need to be less extensive than the updating procedures for a control tested through May for a calendar year-end company.
- *The possibility that there have been any significant changes in internal control over financial reporting subsequent to the interim date.* The more indicators the auditor has that signal that a control has not changed since the interim testing date, the less extensive the updating procedures should be. For example, if the auditor understands that there have been no changes in the design of the control, the business operations surrounding the control, the personnel performing the control, or other factors, the less extensive the updating procedures need to be. On the other hand, if management has implemented a restructuring of significant processes that affect several significant accounts after the auditor's interim testing, such as when personnel are replaced or positions are lost, the auditor's updating procedures would need to be more extensive.

In selecting the nature of the tests to perform, the auditor might choose to perform the following procedures: inquiry, observation, inspection of relevant documentation, and reperformance of a control. The auditor also may perform walkthroughs, which ordinarily consist of some combination of these types of procedures. These procedures are listed in the order of the general level of persuasiveness of the evidence that they ordinarily would produce, from lowest to highest. For example, "inspection" might include scanning monthly account



Auditing Standard No. 2 – Internal Control
May 16, 2005

STAFF QUESTIONS & ANSWERS

reconciliations to determine that the control was performed on a timely basis during the period between the interim testing and year-end.

Specific examples of roll-forward procedures.
Appendix B of Auditing Standard No. 2 contains four examples of how to apply the requirements in paragraphs 88 through 107 of the standard regarding the nature, timing, and extent of testing of internal control over financial reporting. Those examples should be read in their entirety; however, the table below summarizes the timing of the interim testing and the roll-forward procedures illustrated in the examples.

Examples of Extent-of-Testing Decisions	Timing of Interim Testing	Nature and Extent of Roll-forward Procedures
Example B-1 Daily programmed application control and daily information technology-dependent control	Through September	Inquiry and observation
Example B-2 Monthly manual reconciliation	May and July	Inquiry and inspection
Example B-3 Daily manual preventive control	Through September	Walkthrough of one December transaction
Example B-4 Programmed prevent control and weekly information technology-dependent manual detective control	Through July	Inquiry, observation, and inspection

Q52. How should the auditor evaluate a company's internal control over financial reporting when a company has implemented a significant change to IT that affects the company's preparation of its financial statements?



Auditing Standard No. 2 – Internal Control
May 16, 2005

STAFF QUESTIONS & ANSWERS

A52. To evaluate the effect that a change to the company's IT has on the company's internal control over financial reporting, the auditor should evaluate the company's controls over program development and program changes over the specific planned change to IT, as well as any controls that the company might put in place temporarily during the conversion period. The temporary controls referred to here would include the various procedures, many of which would be manual or IT-dependent manual procedures, that management puts in place to detect and correct errors during the time immediately after the conversion (often referred to as the "shake-down" period).

To evaluate whether the company's controls provide management with reasonable assurance that the company can produce complete and accurate financial statements before, during, and after the change to IT, the auditor should evaluate the combination of all these various types of controls.

As further discussed in Staff Question No. 43, the auditor's evaluation of company-level controls (and their relative strength or weakness), such as IT general controls, will affect the auditor's assessment of risk and, therefore, the nature, timing, and extent of the auditor's testing of more detailed controls.

It would be inappropriate for the auditor to conclude, as a rule, that management should not implement changes to IT for some arbitrary period of time before year-end.

Q53. Does Auditing Standard No. 2 encourage a mindset that in the absence of documentation evidencing the performance of a control, the control should be presumed to be ineffective in its operation?

A53. No. Auditing Standard No. 2 does not contain a presumption that a control is ineffective solely because there is no documentation evidencing the operation of the control. Such a presumption might suggest an emphasis on a "sign-and-file" mentality for management's approach to maintaining effective internal control — that a signature or other evidence of the performance of a control might become more important than the performance of the control itself. Rather, Auditing Standard No. 2 emphasizes the importance of obtaining evidence that is sufficiently persuasive to support a conclusion about whether a



Auditing Standard No. 2 – Internal Control
May 16, 2005

STAFF QUESTIONS & ANSWERS

control is operating effectively. Accordingly, the absence of documentation evidencing the operation of an individual control is not determinative that the control is not operating effectively. The auditor must be satisfied, however, that the control actually operated.

Using the Work of Others

Q54. How does the auditor's assessment of risk associated with particular controls and the decision to use the work of others relate to the auditor's determination of whether he or she has obtained the principal evidence supporting his or her opinion?

A54. As discussed in Staff Question No. 40, the auditor's degree of reliance on the work of others should be naturally responsive to the degree of risk associated with the testing of those controls. The requirements in paragraph 116 of Auditing Standard No. 2 that the auditor perform the walkthroughs himself or herself, and the requirements in paragraph 113 that the auditor not use the work of others to reduce the amount of work that he or she performs on controls in the control environment, directly relate to the degree of risk associated with these areas. In other words, because these areas of testing are at the very high end of the scale of audit risk, the auditor should perform this work himself or herself. These specific directions ensure that what should have been a natural result from the auditor's assessment of risk would, in fact, occur in all circumstances.

Having followed the principles in the standard regarding evaluating the nature of the controls subjected to the work of others and evaluating the competence and objectivity of the individuals who performed the work, the auditor should have (1) naturally allocated his or her own work to the areas of highest risk, and (2) generally, already obtained the principal evidence supporting his or her opinion. The note to paragraph 108 of Auditing Standard No. 2 states the following:

Because the amount of work related to obtaining sufficient evidence to support an opinion about the effectiveness of controls is not susceptible to precise measurement, the auditor's judgment about whether he or she has obtained the principal evidence for the opinion will be qualitative as well as quantitative. For example, the auditor might give more weight to work he or she performed on pervasive controls and in areas such as the control environment



Auditing Standard No. 2 – Internal Control
May 16, 2005

STAFF QUESTIONS & ANSWERS

than on other controls, such as controls over low-risk, routine transactions.

This note means that the auditor's evaluation of whether he or she has obtained the principal evidence supporting his or her opinion is primarily qualitative. As described above, the auditor should perform more work himself or herself in areas that represent higher risk. Likewise, the auditor should ascribe more weight to work he or she performs in higher-risk areas. In this manner, in most circumstances, following the other risk-based principles regarding using the work of others will result in the auditor having obtained the principal evidence supporting his or her opinion.

Auditor's Responsibilities With Respect to Management's Certification Disclosures

Q55. Paragraphs 202 through 206 of Auditing Standard No. 2 describe the auditor's responsibilities as they relate to management's quarterly certifications on internal control over financial reporting. Is the auditor required to perform the same types of tests of controls that support his or her opinion on internal control over financial reporting as of year-end on a quarterly basis to determine whether any change in internal control over financial reporting has materially affected the company's internal control over financial reporting?

A55. No. The procedures that the auditor is required to perform on a quarterly basis by paragraph 203 of Auditing Standard No. 2 ordinarily are limited to inquiry and observation and an evaluation of the implications of any misstatements identified by the auditor during the auditor's required review of interim financial information. Paragraphs 202 through 206 of Auditing Standard No. 2 do not require — and should not be read to encourage — what might amount to a quarterly audit of internal control over financial reporting. Rather, the auditor's responsibilities related to management's quarterly certifications on internal control over financial reporting are analogous to the auditor's responsibilities related to the company's financial statements in an interim review of financial statements in accordance with AU sec. 722, *Interim Financial Information*.



Auditing Standard No. 2 – Internal Control
May 16, 2005

STAFF QUESTIONS & ANSWERS

For example, in conducting the inquiries and observations, the auditor ordinarily would limit these procedures to members of management within the company who would be expected to have knowledge about significant changes in the design or operation of internal control over financial reporting. These inquiries and observations should not result in the auditor interviewing every one of the company's employees with whom the auditor would interact during a complete audit of internal control over financial reporting.

As another example, if management plans, in connection with a quarterly certification, to disclose that it has eliminated a previously reported material weakness, the auditor's procedures would be limited to inquiry and observation. In connection with management's quarterly certification, the auditor is not required to test the design or operating effectiveness of controls that management believes eliminate a material weakness beyond inquiry and observation.



1666 K Street, NW
Washington, D.C. 20006
Telephone: (202) 207-9100
Facsimile: (202) 862-8430
www.pcaobus.org



Proposed Auditing Standard on
Reporting on the Elimination
of a Material Weakness
March 31, 2005

BRIEFING PAPER

PROPOSED AUDITING STANDARD ON REPORTING ON THE ELIMINATION OF A MATERIAL WEAKNESS

MARCH 31, 2005 PUBLIC MEETING OF THE BOARD

At its public meeting on March 31, 2005, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") will consider whether to propose and seek comment on an auditing standard, *Reporting on the Elimination of a Material Weakness*. This briefing paper highlights the reasons for such a standard and the more significant provisions of the proposed auditing standard.

Reasons for Standard

Section 404 of the Sarbanes-Oxley Act of 2002 ("the Act") requires public companies to annually provide the investing public with an assessment of the company's internal control over financial reporting. This assessment must be accompanied by an independent auditor's report attesting to management's assessment. As companies have begun to include these reports in their annual financial statement filings, investors are receiving more information about the company's financial operations than was available to them in the past.

In some cases, the company's management and auditor agree that the company's internal control over financial reporting is effective. In other cases, however, management's assessment of the company's internal control over financial reporting may reveal that the company has one or more material weaknesses – a serious defect in the company's internal control over financial reporting. Until investors learn that the material weakness has been eliminated, they may be uncertain about the reliability of the company's financial statements.

BRIEFING PAPER

Management may determine that communicating the elimination of a material weakness through its quarterly disclosures will be sufficient to notify investors. Some investors and companies, however, have called for a mechanism for confirmation by the company's independent auditor of management's assertions about those internal control improvements.^{1/} Such confirmation is not required by the Act or other securities laws, but, in appropriate cases, could provide companies with an additional vehicle for communicating with the markets. The proposed standard, therefore, would establish requirements for an entirely elective engagement to provide auditor assurance about the elimination of a material weakness.

Significant Provisions of Standard

The proposed standard is more narrowly focused than Auditing Standard No. 2, which applies to the auditor's annual report on the effectiveness of internal control over financial reporting, but draws from many of that standard's concepts. To perform an engagement to report on the elimination of a material weakness, the auditor must have sufficient overall knowledge of both the company and its internal control over financial reporting. The auditor's objective in an engagement to report on the elimination of a material weakness is to express an opinion on whether a previously reported material weakness has been eliminated.

Because an engagement to report on the elimination of a material weakness would be significantly narrower in scope than an audit of internal control over financial reporting, the auditor's testing would be limited to the controls specifically identified by management as eliminating the material weakness. Both management and the auditor would use the company's stated control objectives as the target for determining whether the specified controls eliminate the material weakness. This approach relies on

^{1/} The Board's Standing Advisory Group ("SAG") discussed possible auditor involvement with the elimination of a material weakness at its November 18, 2004 public meeting. Several SAG members strongly encouraged the Board to undertake a standards-setting project of this nature because they predicted that both investors and issuers would request auditor assurance on a company's elimination of a material weakness. The webcast of the November 18, 2004 Standing Advisory Group discussion is available on the Board's Web site (www.pcaobus.org).



Proposed Auditing Standard on
Reporting on the Elimination
of a Material Weakness
March 31, 2005

BRIEFING PAPER

management and the auditor reaching agreement regarding which deficient control objective caused the material weakness.

To render an unqualified opinion, the auditor must have obtained evidence about the design and operating effectiveness of the specifically identified controls, determined that the material weakness has been eliminated, and determined that no scope limitations were placed on the auditor's work.

In keeping with the voluntary nature of this reporting, the proposed standard allows for significant flexibility in the performance of an engagement to report on the elimination of a material weakness. For example:

- The engagement could be undertaken at any time during the year and would not have to be performed in conjunction with an audit or review of financial statements.
- The proposed standard would allow an auditor to report on the elimination of one or more material weaknesses as part of a single engagement.
- Consistent with the framework for using the work of others that Auditing Standard No. 2 established, the proposed standard would permit the auditor to use the work of others to alter the nature, timing, and extent of the auditor's work.
- If the auditor determines that the material weakness has not been eliminated, the proposed standard would allow the company to re-address its remediation efforts, reset the assertion date and request that the auditor begin testing again in order to opine on the elimination of the material weakness. In this situation, the auditor would, however, be required to communicate his or her conclusion that the material weakness had not yet been eliminated to the company's audit committee.

Auditor assurance that a material weakness has been eliminated as of an interim date may not always be possible. For example, a company might have ineffective internal control over financial reporting at year-end because of pervasive weaknesses in its control environment. Because the control environment can have significant effects on other components of internal control over financial reporting, it might not be possible



Proposed Auditing Standard on
Reporting on the Elimination
of a Material Weakness
March 31, 2005

BRIEFING PAPER

for management or the auditor to conclude on the effectiveness of the control environment without evaluating, and testing, the effects of the corrective action on the other internal control components. Therefore, this type of interim engagement, with its narrow scope, may not be suitable for auditor reporting on the elimination of certain kinds of material weaknesses.

Effective Date of the Proposed Standard

The standard would be effective as of the date of SEC approval.

Public Comment

If the Board issues the proposed standard, it will seek comment on the proposed standard for a 45-day period. The Board will carefully consider all comments received. Following the close of the comment period, the Board will determine whether to adopt a final standard, with or without amendments. Any final standard adopted will be submitted to the Securities and Exchange Commission for approval. Pursuant to Section 107 of the Act, proposed rules of the Board do not take effect unless approved by the Commission. Standards are deemed to be rules under the Act.

* * *

The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.



1666 K Street, NW
Washington, D.C. 20006
Telephone: (202) 207-9100
Facsimile: (202) 862-8430
www.pcaobus.org



Reporting on Whether a Previously
Reported Material Weakness
Continues to Exist
July 26, 2005

BRIEFING PAPER

BOARD CONSIDERS ADOPTING AUDITING STANDARD ON REPORTING ON WHETHER A PREVIOUSLY REPORTED MATERIAL WEAKNESS CONTINUES TO EXIST

JULY 26, 2005 PUBLIC MEETING OF THE BOARD

At its public meeting on July 26, 2005, the Public Company Accounting Oversight Board (the "Board" or "PCAOB") will consider whether to adopt an auditing standard, *Reporting on Whether a Previously Reported Material Weakness Continues to Exist*. This briefing paper highlights the need for such a standard and the more significant provisions of the auditing standard that the Board will consider adopting.

Reasons for Standard

Section 404 of the Sarbanes-Oxley Act of 2002 ("the Act") requires public companies to annually provide the investing public with an assessment of the company's internal control over financial reporting. This assessment must be attested to, and reported on, by the company's registered public accounting firm. Investors have already begun to benefit from the increased transparency that these reports provide.

In many cases, the company's management and auditor agree that the company's internal control over financial reporting is effective. In some cases, however, management's assessment of the company's internal control over financial reporting reveals that the company has one or more material weaknesses – a serious defect in internal control over financial reporting. Until investors learn that the material weakness no longer exists, they may be uncertain about the reliability of the company's financial reporting.

Companies may update the markets about the status of previously reported material weaknesses through a variety of available mechanisms. Some investors and companies, however, have called for an additional mechanism that would provide for confirmation of internal control improvements by the company's registered public accounting firm. Such confirmation is not required by the Act or other securities laws, but, in appropriate cases, could provide companies with an additional vehicle for

BRIEFING PAPER

communicating with the markets. The standard, therefore, would establish and describe an entirely elective engagement to provide auditor assurance that a specified material weakness no longer exists.

Significant Provisions of Standard

The standard under consideration is designed to be more narrowly focused than Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, but draws from many of that standard's concepts. The auditor's objective in performing an engagement pursuant to the proposed standard would be to express an opinion on whether a previously reported material weakness continues to exist.

Both management and the auditor would use the company's stated control objectives as the target for determining whether the material weakness no longer exists. The auditor's testing in this engagement would be limited to the specific controls necessary to achieve those control objectives. To render an opinion stating that a material weakness no longer exists, the auditor must have obtained evidence about the design and operating effectiveness of the specifically identified controls, determined that those controls satisfy the control objectives, and determined that no scope limitations were placed on the auditor's work.

The standard allows for significant flexibility in the performance of an engagement to report on whether a previously reported material weakness continues to exist. For example:

- The engagement could be undertaken at any time during the year and would not have to be performed in conjunction with an audit or review of financial statements.
- The standard would allow an auditor to report on whether one or more material weaknesses continue to exist as part of a single engagement.
- Consistent with the framework for using the work of others that Auditing Standard No. 2 established, the standard would permit the auditor to use



Reporting on Whether a Previously
Reported Material Weakness
Continues to Exist
July 26, 2005

BRIEFING PAPER

the work of others to alter the nature, timing, and extent of the auditor's work.

- If the auditor determines that the material weakness still exists, the auditor would be required to communicate his or her conclusion that the material weakness still exists to the company's audit committee. However, management also would have the ability to continue its remediation efforts, make another assertion at a later date as to whether the material weakness still exists, and re-engage the auditor to report on its assertion.

Effective Date of the Proposed Standard

The standard would be effective as of the date of SEC approval.

* * *

The PCAOB is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent audit reports.

Auditing Standard Number 2 and the Role of Corporate Counsel

Presentation by Mary M. Sjoquist
Special Counsel to Board Member Bill Gradison
Association of Corporate Counsel Annual Meeting
October 19, 2005



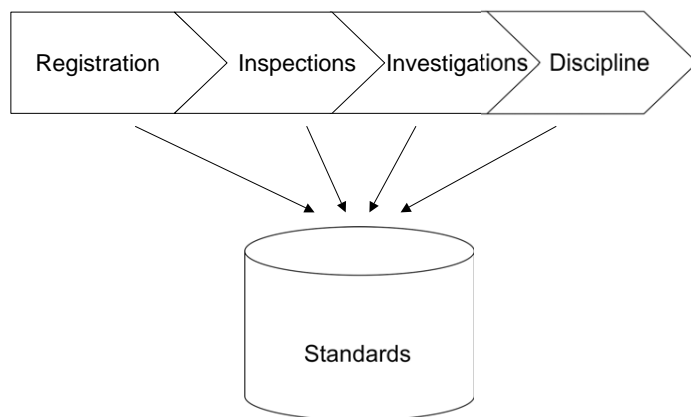
Caveat

*The opinions I express are my own,
and do not necessarily represent the views
of the PCAOB, its members
or its staff.*

Outline of Presentation

- Brief Overview of PCAOB
- Statutory Basis for AS No 2
- Brief Overview of AS No 2
- Activities Since Adoption of AS No 2
- How Can Corporate Counsel Help
 - Understanding
 - Myths and Dispelling Myths
 - Advising and Interpreting AS No 2

The PCAOB's Responsibilities



Standard-Setting

AS # 2 – An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements

- Section 103(2)(A)(3) of SOX—requirements—The Board shall include in the standards, requirements that each registered firm include in its audit reports, the scope of the auditor's testing of internal control structure and procedures of the issuer and describe
 - Findings of auditor from testing
 - Evaluation of whether the structure and procedures include reasonably detailed maintenance of records and reasonable assurance that transactions are being recorded in accordance with GAAP
 - A description of material weaknesses
- Section 404(b) of SOX requires the auditor to attest to and report on the assessment made by management of the issuer. The attestation cannot be the subject of a separate engagement
- Standard adopted by Board on March 9, 2004 and approved by the SEC on June 16, 2004

Overview of AS No. 2

The audit of ICFR can be viewed as a seven-phase process:

- Planning the engagement. (¶39)
- Evaluating management's internal control assessment. (¶40-46)
- Obtaining an understanding of overall design and operation of controls. (¶47-87)
- Testing and evaluating design effectiveness of controls. (¶88)
- Testing and evaluating operating effectiveness of controls. (¶89-126)
- Forming an opinion on effectiveness. (¶127-141)
- Reporting the results of the audit of internal control. (¶162-199)

AS No 2 Reporting

- **The Report contains two opinions**
 - **Opinion on management's assessment**
 - **Opinion on the effectiveness of internal control over financial reporting**
- **The report on internal control and the report on the financial statements may be included in one or separate documents. If separate, they must be dated as of the same date.**

Summary of Section 404 Activities

- Auditor and issuer working groups
- Frequently asked question
 - June 23, October 6, November 22/04, January 21/05
- Small Business Forums—November 2004-October 2005
- AS No 4—Reporting on Whether a Previously Existing Material Weakness Exists
- Internal control roundtable, April 13, 2005
- Policy Statement and additional FAQs, May 16, 2005
- SEC Statement on Internal Control Over Financial Reporting
- June 8 and 9 Standing Advisory Group Meeting
- COSO guidance—smaller companies
- SEC Small Business Advisory Committee Recommendations

Auditing Standard No 2 and the Role of Corporate Counsel

- Understanding
 - Auditing Standard No. 2
 - Frequently Asked Questions
 - Board Policy Statement
 - Board and Staff Speeches
- Interpreting and Advising

Understanding--Myths about AS No.2

- Myth 1:Auditors cannot advise their clients about accounting and control issues
- Myth 2:All controls have the same level of relevancy
- Myth 3:Auditors cannot rely on the work of issuer personnel in performing the audit of internal control
- Myth 4:AS No 2 discourages auditors from exercising judgment
- Myth 5:Controls at companies of all sizes must meet the same criteria—"one-size-fits-all"
- Myth 6:If the performance of a control wasn't documented by management, the control was ineffective in operation.

Understanding--Bases for Myths

- Fear of litigation
- Overreaction to increased regulation
- Fear of new independent oversight regime—PCAOB inspections process
- Fear of compromising firm independence
- First time auditors or issuers ever implemented this standard
- Lack of familiarity with new standard
- Lack of trained personnel at both auditors and issuers

Understanding--Dispelling the Myths

Myth 1: Auditors cannot advise their clients about accounting and control issues—resulting in stone wall and could result in less effective financial statements

- AS No 2
 - ¶32 permits the auditor to improve on the design or operation of internal control as a by-product of the audit
 - Standard does not say that information cannot be shared or that advice may not be provided by the auditor
- FAQ 7—June 23, 2004—provides clarification that some information-sharing is absolutely essential—drafts of financial statements, complex accounting pronouncements, acceptance of auditor prepared checklists
- Board Policy Statement—May 16, 2005—The Auditor's Ability to Provide Advice to Audit Clients

Understanding--Dispelling the Myths

Myth 2—All controls have the same level of relevancy—resulting in over auditing and increased costs

- AS No 2
 - ¶52-84 provide a step-by-step sequence for the top-down approach for the audit of ICFR
 - ¶ 52—Company level controls have a pervasive effect on all other controls and include tone at the top, policies, codes of conduct, fraud prevention, risk assessment process and period-end financial reporting process.
 - Risk assessment by the auditor underlies the entire audit process described in AS No 2
- FAQ 38 describes the top-down approach which should result in the auditor spending less time and effort in understanding controls not relevant to whether the financial statements could be materially misstated.
- FAQ 39-43 describe the risk-based approach to the audit and the resultant effect of the nature, timing and extent of the auditor's work on internal control.
- Board Policy Statement—Stresses the top-down approach and the role of risk assessment

Understanding--Dispelling the Myths

Myth 3—Auditors cannot rely on the work of issuer personnel in the ICFR audit—resulted in over auditing and increased costs

- AS No 2--¶112 to 126
 - Objectivity and competency of staff performing the work
 - Principle evidence rule
- FAQ 20-23, 36 and 54
 - Principal evidence is primarily qualitative
 - More work should be done in higher risk areas—control environment, detection of fraud
 - More weight should be placed on work done by auditor in higher risk areas.
- Board Policy Statement—Using the Work of Others
 - Using the work of others and the principle evidence rule do not conflict
 - Auditor must perform sufficient auditing to reach independent opinion about effectiveness of ICFR

Understanding--Dispelling the Myths

Myth 4—AS No 2 discourages auditors from using judgment in the audit of ICFR.

- AS No 2
 - Auditing standards generally including AS No 2 call for the use of judgment by the auditor
 - Objective is to obtain evidence that a company's control system "reasonably assures that its financial statements do not contain material misstatements"
 - ¶ 83 of AS No 2 sets forth the factors to be evaluated in identifying which controls to test
- FAQ
 - ¶ 39-43 regarding "risk-based" approach to auditing
 - ¶ 43—auditor doesn't need to test all controls identified as "key" or "significant by management
 - ¶ 48 and 49—relate to managements testing and whether or not it can reduce the number of controls tested
- Board Policy Statement—The Importance of Professional Judgment—auditors have always used auditing standards to tailor audit plans to address the nature and complexity of the audit client.

Understanding--Dispelling the Myths

Myth 5-One-size-fits-all

- AS No 2
 - Use of auditor judgment
 - Goal of reasonable assurance not absolute assurance
 - COSO framework—discusses special considerations for internal control over financial reporting for small and medium-sized companies
- Board Policy Statement—The Importance of Professional Judgment
 - In 2004, auditors frequently used one-size-fits-all audit plan driven by check lists
 - Disregard of unique issues and risks
 - Excess hours spent on process level controls
 - Disregard of specific industry or size

Understanding--Dispelling the Myths

Myth 6—If the performance of a control wasn't documented by management, it wasn't performing effectively

- AS No 2
 - ¶ 42-46—Describes what the auditor should review to determine whether management's documentation provides reasonable support for its assessment
 - Paragraph 138—Inadequate design and absence of sufficient documented evidence to support management's assessment of the operating effectiveness are control deficiencies
- FAQ 53—No presumption that the control "is" ineffective as a result of absence of documentation. Auditor must be satisfied by sufficiently persuasive evidence that the control actually operated.

Interpreting and Advising—Company-Level and Anti-Fraud Controls

AS No 2—¶24-26—Fraud Considerations in an Audit of Internal Control Over Financial Reporting

- Auditor must evaluate all controls specifically intended to address the risks of fraud that have a reasonable likelihood of having a material effect on the company's financial statements.
- Some of these controls may be outside of the area generally associated with ICFR and within the purview of corporate counsel
 - Risk assessment processes, including Board-approved policies that address significant business control and risk management practices
 - Code of ethics provisions—conflicts on interest, related party transactions, illegal acts, monitoring of the codes by management and the audit committee
 - Adequacy of the internal audit activity—objectivity
 - Handling of complaints and acceptance of confidential submissions of concerns about questionable accounting or auditing matters
- Auditors will review these types of controls

Interpreting and Advising—Pre-approval Policies

- SEC's independence rules require pre-approval of non-audit services provided by the auditor
 - Approved by the audit committee; or
 - Entered into pursuant to pre-approval policies and procedures established by the audit committee
- AS No2, ¶33
 - Internal control related services must be specifically pre-approved by the audit committee
 - Management must be actively involved in those services; can't delegate responsibility of these matters to the auditor
 - Involvement must be substantive and extensive
 - Acceptance of responsibility for documentation and testing by the auditor won't satisfy independence requirements
- Since financial statement audit and ICFR audit must be completed by the same auditor, if independence is impaired by violations of ¶33, a change in auditors would be required.

Interpreting and Advising—Audit Committee Evaluation

- AS No 2, ¶140 provides that where the auditor finds that the oversight of the company's external financial reporting and ICFR by the company's audit committee is ineffective, there is a significant deficiency and a strong indicator of a material weakness.
- The evaluation of the audit committee is a part of the evaluation of the overall control environment
- AS No 2, ¶55-59 describes factors for auditors to focus on including:
 - Independence of members from management
 - Articulation of committee's responsibilities
 - Understanding by committee and management of these responsibilities
 - Interaction with auditor, internal audit and key management
 - Does the committee ask the right questions of management and the auditor that indicate understanding of critical accounting policies and judgmental estimates
 - Is the audit committee responsive to questions raised by the auditor
- Corporate counsel can help to assure that the committee members are well-prepared and to monitor and document on-going activities.

Advising and Interpreting—Advice to Audit Committee Regarding Significant Deficiencies and Material Weaknesses

- Expect deficiencies—especially in year one
- Ask why the auditor characterized deficiencies as they did?
- Ask whether management's characterization of deficiencies differed from the auditor's and, if so, why?
- Make certain that members understand the implications of significant deficiencies and management's remedial plan
- Advise members to treat the analysis and correction of any material weakness as a top priority
- Assure that members consider the nature and completeness of proposed disclosures of any material weakness
- Make certain that members understand and consider AS No 4 engagements—Reporting on Whether a Previously Reported Material Weakness Exists