

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 210, 228, 229 and 240

[RELEASE NOS. 33-8809; 34-55928; FR-76; File No. S7-24-06]

RIN 3235-AJ58

Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting

AGENCY: Securities and Exchange Commission.

ACTION: Final rule.

SUMMARY: We are adopting an amendment to our rules to clarify that an evaluation which complies with the Commission's interpretive guidance published in this issue of the Federal Register in Release No. 34-55929 is one way to satisfy the requirement for management to evaluate the effectiveness of the issuer's internal control over financial reporting. We are also amending our rules to define the term material weakness and to revise the requirements regarding the auditor's attestation report on the effectiveness of internal control over financial reporting. The amendments are intended to facilitate more effective and efficient evaluations of internal control over financial reporting by management and auditors.

EFFECTIVE DATE: August 27, 2007, except the amendment to §210.2-02T is effective from August 27, 2007 until June 30, 2009.

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SUPPLEMENTARY INFORMATION: We are adopting amendments to Rules 13a-15(c),¹ 15d-15(c),² and 12b-2³ under the Securities Exchange Act of 1934 (the “Exchange Act”),⁴ Rules 1-02,⁵ 2-02⁶ and 2-02T⁷ of Regulation S-X,⁸ and Item 308 of Regulations S-B and S-K.⁹

In a companion release issued in today’s Federal Register, we are issuing interpretive guidance to assist companies of all sizes in completing top-down, risk-based evaluations of internal control over financial reporting.¹⁰ In addition, we are issuing a release to request additional comment on the definition of the term “significant deficiency.”¹¹

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¹ 17 CFR 240.13a-15(c).

² 17 CFR 240.15d-15(c).

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⁴ 15 U.S.C. 78a et seq.

⁵ 17 CFR 210.1-02.

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⁸ 17 CFR 210.1-01 et seq.

⁹ 17 CFR 228.308 and 229.308.

¹⁰ Release No. 34-55929 (Jun. 20, 2007) (hereinafter “Interpretive Guidance”).

¹¹ Release No. 34-55930 (Jun. 20, 2007).

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I. BACKGROUND

In implementing Section 404(a) of the Sarbanes-Oxley Act of 2002¹² (“Sarbanes-Oxley”), the Commission adopted amendments to Exchange Act Rules 13a-15 and 15d-15 to require companies, other than registered investment companies, to include in their annual reports filed pursuant to Section 13(a) or 15(d)¹³ of the Exchange Act a report by management on the company’s internal control over financial reporting (“ICFR”) and a

¹² 15 U.S.C. 7262.

¹³ 15 U.S.C. 78m(a) or 78o(d).

registered public accounting firm's attestation report on ICFR. Rules 13a-15 and 15d-15 also require management of each company to evaluate the effectiveness, as of the end of each fiscal year, of the company's ICFR.¹⁴

On December 20, 2006, the Commission issued a proposing release that contained interpretive guidance for management ("Proposed Interpretive Guidance") regarding its required evaluation of ICFR and amendments to Exchange Act Rules 13a-15(c) and 15d-15(c) to make it clear that an evaluation conducted in accordance with the Proposed Interpretive Guidance was one way to satisfy the annual management evaluation required by those rules. In addition, we proposed amendments to Rule 2-02(f) of Regulation S-X to require that the registered public accounting firm's attestation report on ICFR express a single opinion directly on the effectiveness of ICFR, and to clarify the circumstances in which we would expect that the accountant cannot express an opinion on ICFR. We also proposed amendments to Rule 1-02(a)(2) of Regulation S-X to revise the definition of attestation report to conform it to the proposed changes to Rule 2-02(f).¹⁵

We received over 200 comment letters in response to our Proposing Release.¹⁶ These letters came from corporations, professional associations, large and small accounting firms, law firms, consultants, academics, investors and other interested parties. Of these, approximately 70 respondents commented on the proposed rule

¹⁴ Release No. 33-8238 (June 5, 2003) [68 FR 36636] (hereinafter "Adopting Release"). See Release No. 33-8392 (Feb. 24, 2004) [69 FR 9722] for compliance dates applicable to accelerated filers. See Release No. 33-8760 (Dec. 15, 2006) [71 FR 76580] for compliance dates applicable to non-accelerated filers.

¹⁵ Release Nos. 33-8762; 34-54976 (Dec. 20, 2006) [71 FR 77635] (hereinafter "Proposing Release").

¹⁶ The comment letters are available for inspection in the Commission's Public Reference Room at 100 F Street, NE, Washington, DC 20549 in File No. S7-24-06, or may be viewed at <http://www.sec.gov/comments/s7-24-06/s72406.shtml>.

amendments. We have reviewed and considered all of the comments that we received on the proposed rule amendments. The adopted rules reflect changes made in response to many of these comments. We discuss our conclusions with respect to each proposed rule amendment and the related comments in more detail throughout this release.

II. DISCUSSION OF AMENDMENTS

A. Exchange Act Rules 13a-15(c) and 15d-15(c)

1. Proposal

Exchange Act Rules 13a-15(c) and 15d-15(c) require the management of each issuer subject to the Exchange Act reporting requirements, other than a registered investment company, to evaluate the effectiveness of the issuer's ICFR as of the end of each fiscal year. We proposed to amend these rules to state that, although there are many different ways to conduct an evaluation of the effectiveness of ICFR, an evaluation conducted in accordance with the Proposed Interpretive Guidance would satisfy the evaluation requirement in those rules.

2. Comments on the Proposal

While many commenters supported the proposed amendments to Rules 13a-15 and 15d-15,¹⁷ some expressed the view that although the guidance is appropriately principles-based, the nature of the requirements set forth in the Proposed Interpretive Guidance is not well-suited to the type of safe-harbor protection intended by the

¹⁷ See, for example, letters from America's Community Bankers (ACB), BP p.l.c. (BP), Business Roundtable, Enbridge Inc., European Association of Listed Companies, Hudson Financial Solutions (Hudson), ING Groep N.V. (ING), PPL Corporation (PPL), Silicon Valley Leadership Group (SVLG), The Hundred Group of Finance Directors (100 Group), and UnumProvident Corporation (UnumProvident).

amendments.¹⁸ For instance, three commenters suggested that the Proposed Interpretive Guidance does not contain specific, objective criteria that a company's management could use to demonstrate that its evaluation complies with the requirements of the Proposed Interpretive Guidance.¹⁹ Consequently, two of these commenters went on to conclude that the amendments may eventually lead to the Interpretive Guidance being viewed as an exclusive evaluation approach. In light of these and similar concerns, one commenter suggested broadening the amended rule language to explicitly indicate that an evaluation provides a reasonable basis for management's ICFR assessment if it includes: (1) an identification of the risks that are reasonably likely to result in a material misstatement of the company's financial statements; (2) an evaluation of whether the company has placed controls in operation that are designed to address those risks; and (3) a risk-based process for gathering and evaluating evidence regarding the effective operation of those controls.²⁰

One commenter opposed both the Proposed Interpretive Guidance and the proposed rule amendments and expressed the view that management will, as a result of the nature of the Proposed Interpretive Guidance, claim the protection afforded by the amendments for deficient evaluations.²¹ Another commenter expressed the view that the

¹⁸ See, for example, letters from American Electronics Association (AeA), James J. Angel, Cleary Gottlieb Steen & Hamilton LLP (Cleary), Financial Reporting Committee of the Association of the Bar of the City of New York (NYC Bar), and U.S. Chamber of Commerce (Chamber).

¹⁹ See, for example, letters from Cleary, NYC Bar, and Reznick Group, P.C.

²⁰ See letter from Cleary.

²¹ See joint letter from Consumer Federation of America, Consumer Action, and U.S. Public Interest Research Group.

proposed rule amendments could result in a “minimalist” attitude towards the internal control evaluation on the part of management.²²

3. Final Rule

After consideration of the comments that we received, we have determined to adopt the amendments to Rules 13a-15(c) and 15d-15(c) as proposed. The amended rules state that there are many different ways to conduct an evaluation that will satisfy the evaluation requirement in the rules, and the Interpretive Guidance clearly states that compliance with the guidance is voluntary. Therefore, concerns that the amendments may cause confusion as to whether compliance with the Interpretive Guidance is mandatory or may result in an exclusive standard are unfounded. We understand that many companies already complying with the Section 404 requirements have established an ICFR evaluation process that may differ from the approach described in the Interpretive Guidance. There is no requirement for these companies to alter their procedures to align them with the Interpretive Guidance.

We have decided not to broaden the amended rule language to include factors to consider in determining whether alternative methods satisfy the standard primarily because we think this type of “broadening” may actually limit the potential universe of acceptable evaluation methods. For example, while we believe the Interpretive Guidance’s top-down, risk-based approach will result in both effective and efficient evaluations of the effectiveness of ICFR, management may choose to establish an alternative evaluation approach. An alternative approach may be deemed preferable if it complements a company’s existing quality improvement processes or enterprise risk

²² See letter from Tatum LLC.

management methodologies and still provides management with a reasonable basis for its assessment of ICFR effectiveness. Therefore, we do not think it is appropriate or necessary to mandate the approach set forth in the Interpretive Guidance.

Regarding the comments expressing concern that the principles-based nature of the Proposed Interpretive Guidance may not easily lend itself to the safe-harbor type provisions, we acknowledge that the amendments to Rules 13a-15 and 15d-15 are of a somewhat different nature from other safe-harbor provisions, which typically prescribe very specific conditions that must be met before a company or person may claim protection under the safe-harbor. Nonetheless, we believe establishing the Interpretive Guidance as one way to satisfactorily evaluate ICFR will serve the important purpose of communicating the objectives and requirements of the ICFR evaluation. Moreover, most commenters preferred that the guidance for conducting an evaluation of ICFR be issued on an interpretive basis rather than codified as a rule.²³ Accordingly, a direct reference in the rules to the Interpretive Guidance will help ensure that companies are aware of the guidance.

We are issuing the Interpretive Guidance, and taking a series of other steps, to improve and strengthen implementation of the ICFR requirements. Regardless of whether management uses the Interpretive Guidance, we remain committed to a strong implementation of the ICFR requirements and to ensuring that issuers perform a sufficient evaluation. As is currently the case, the sufficiency of an evaluation will be determined based on each issuer's particular facts and circumstances.

²³ Approximately thirty-three commenters directly responded to the question about whether the guidance should be issued as an interpretation or codified as a Commission rule. Approximately 70% of such respondents indicated that the guidance should be issued as an interpretation.

B. Rules 1-02 and 2-02 of Regulation S-X and Item 308 of Regulations S-B and S-K

1. Proposal

Rule 2-02(f) of Regulation S-X requires the registered public accounting firm's attestation report on management's assessment of ICFR to clearly state the "opinion of the accountant as to whether management's assessment of the effectiveness of the registrant's ICFR is fairly stated in all material respects." The term "assessment" as used in Rule 2-02(f) refers to management's disclosure of its conclusion about the effectiveness of the company's ICFR, not the efficacy of the process followed by management to arrive at its conclusion. To more effectively communicate the auditor's responsibility in relation to management's assessment, we proposed to revise Rule 2-02(f) to require the auditor to express an opinion directly on the effectiveness of ICFR. We believe this opinion necessarily conveys whether the disclosure of management's assessment is fairly stated. In addition, we proposed revisions to Rule 2-02(f) to clarify the rare circumstances in which the accountant would be unable to express an opinion.

We also proposed conforming revisions to the definition of attestation report in Rule 1-02(a)(2) of Regulation S-X. The PCAOB proposed a conforming revision to its auditing standard to reflect this revision as well.²⁴

2. Comments on the Proposal

We received comments on the proposed revisions to Rules 1-02(a)(2) and 2-02(f) of Regulation S-X to require the expression of a single opinion directly on the effectiveness of ICFR by the auditor in the attestation report on ICFR. Those who

²⁴ PCAOB Release No. 2006-007: Proposed Auditing Standard – An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements. See http://www.pcaobus.org/Rules/Docket_021/index.aspx (hereinafter "Proposed Auditing Standard").

commented on this proposed amendment were equally divided, with approximately one-half supporting the Commission's proposal to eliminate the auditor's opinion on management's assessment of the effectiveness of ICFR,²⁵ and the other half expressing the view that, although the reduction to one opinion by the auditor was preferable, the opinion retained would limit improvements in the efficiency of the 404 process.²⁶

Commenters who supported the Commission's proposal believe that an auditor's opinion directly on the effectiveness of a company's ICFR provides investors with a higher level of assurance than the opinion only on management's assessment. These commenters also suggested that an audit opinion directly on the effectiveness of ICFR was a clearer expression of the scope of the auditor's work. However, those who opposed the Commission's proposal argued that an audit opinion directly on the effectiveness of ICFR would require duplicative, unnecessary and excessive testing by auditors and would therefore lead to higher audit costs.²⁷ These commenters suggested the auditor's work should be limited to evaluating management's assessment process and the testing performed by management and internal audit. They acknowledged that the auditor would need to test at least some controls directly in addition to evaluating and

²⁵ See, for example, letters from Banco Itaú Holding Financeira SA, BP, Cisco Systems, Inc. (Cisco), Computer Sciences Corporation (CSC), Eli Lilly and Company (Eli Lilly), Frank Consulting, PLLP, Grant Thornton LLP, Kimball International (Kimball), Lubrizol Corporation (Lubrizol), MetLife, Inc. (MetLife), NYC Bar, PPG Industries, Inc. (PPG), The Procter & Gamble Company (P&G), and RAM Energy Resources, Inc.

²⁶ See, for example, letters from 100 Group, Alamo Group, Association of Chartered Certified Accountants (ACCA), BHP Billiton Limited (BHP), European Federation of Accountants (FEE), The Financial Services Roundtable (FSR), Hess Corporation (Hess), Hutchinson Technology Inc. (Hutchinson), Institute of Internal Auditors (IIA), Institute of Management Accountants (IMA), Institut Der Wirtschaftsprüfer [Institute of Public Auditors in Germany] (IDW), Ian D. Lamdin (I. Lamdin), Matthew Leitch, Nasdaq Stock Market, Inc. (Nasdaq), National Venture Capital Association (NVCA), Nike, Inc. (Nike), Robert F. Richter (R. Richter), Rod Scott, Southern Company (Southern), and SVLG.

²⁷ See, for example, letters from 100 Group, ACCA, Hess, Nasdaq, Nike, and Southern.

testing management's assessment process; however, they expected that the auditor's own testing could be significantly reduced from the scope required to render an opinion directly on the effectiveness of ICFR.²⁸ Additionally, commenters were concerned that the proposed rule change was in direct conflict with Section 404(b) of Sarbanes-Oxley, which explicitly calls for the auditor to issue an attestation report on management's assessment of the effectiveness of ICFR.²⁹

In view of the proposal to require only one opinion by the auditor in its report on the effectiveness of a company's ICFR, commenters thought that continued references in Rules 1-02(a)(2) and 2-02(f) of Regulation S-X to an "attestation report on management's assessment of internal control over financial reporting" would be confusing.³⁰ These commenters suggested that we eliminate these references and refer to the auditor's report only as an "attestation report on internal control over financial reporting."

3. Final Rule

After consideration of the comments, we have decided to adopt the proposed amendments to Rules 1-02(a)(2) and 2-02(f) of Regulation S-X to require the expression of a single opinion directly on the effectiveness of ICFR by the auditor in its attestation report on ICFR because it more effectively communicates the auditor's responsibility in relation to management's process and necessarily conveys whether management's assessment is fairly stated. In view of this decision, we agree with commenters that Rules 1-02(a)(2) and 2-02(f) of Regulation S-X will be clearer if they refer to the

²⁸ See, for example, letters from BHP and NVCA.

²⁹ See, for example, letters from FEE, FSR, Hutchinson, IDW, IIA, IMA, I. Lamdin, and R. Richter.

³⁰ See, for example, letters from 100 Group, BDO Seidman LLP, Cleary, Financial Executives International Committee on Corporate Reporting (FEI CCR), Manulife Financial (Manulife), Microsoft Corporation (MSFT), Neenah Paper, Inc (Neenah), and NYC Bar.

auditor’s report as an “attestation report on internal control over financial reporting” rather than an “attestation report on management’s assessment of internal control over financial reporting.” We, therefore, have made this change. We also have made conforming changes to Rule 2-02T of Regulation S-X and Item 308 of Regulations S-B and S-K.³¹

Despite the fact that the revised rules no longer require the auditor to separately express an opinion concerning management’s assessment of the effectiveness of the company’s ICFR, auditors currently are required under Auditing Standard No. 2 (“AS No. 2”),³² and would continue to be required under the Proposed Auditing Standard, to evaluate whether management has included in its annual ICFR assessment report all of the disclosures required by Item 308 of Regulations S-B and S-K. Both AS No. 2 and the Proposed Auditing Standard would require the auditor to modify its audit report on the effectiveness of ICFR if the auditor determines that management’s assessment of ICFR is not fairly stated. Consequently, the revisions are fully consistent with, and will continue to achieve, the objectives of Section 404(b) of Sarbanes-Oxley.

In considering the concerns raised by commenters about the scope of auditor testing that is required to render an opinion directly on the effectiveness of ICFR, the Commission believes that an auditing process that is restricted to evaluating what management has done would not necessarily provide the auditor with a sufficient level of assurance to render an independent opinion as to whether management’s assessment (that is, conclusion) about the effectiveness of ICFR is correct. Moreover, the PCAOB’s

³¹ Item 308 sets forth the ICFR disclosure that must be included in a company’s annual and quarterly reports.

³² [An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements.](#)

auditing standards with respect to a company's ICFR derive from both Section 103(a)(2)(A)(iii) and Section 404(b) of Sarbanes-Oxley. Section 404(b) of Sarbanes-Oxley requires the auditor to "attest to, and report on, the assessment made by the management of the issuer." Section 103(a)(2)(A)(iii) of Sarbanes-Oxley requires that each audit report describe the scope of the auditor's testing of the internal control structure and procedures and present, among other information: (1) the findings of the auditor from such testing; (2) an evaluation of whether such internal control structure and procedures provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles; and (3) a description of material weaknesses in such internal controls.³³

The Commission believes that an audit opinion directly on the effectiveness of ICFR is consistent with both Section 404 and Section 103 of Sarbanes-Oxley. Further, the Commission believes that the expression of a single opinion directly on the

³³ Section 103(a)(2)(A)(iii) states that "each registered public accounting firm shall -- describe in each audit report the scope of the auditor's testing of the internal control structure and procedures of the issuer, required by section 404(b), and present (in such report or in a separate report) --

- (I.) the findings of the auditor from such testing;
- (II.) an evaluation of whether such internal control structure and procedures --
 - (aa) include maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
 - (bb) 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
- (III.) a description, at a minimum, of material weaknesses in such internal controls, and of any material noncompliance found on the basis of such testing."

effectiveness of ICFR clarifies that an auditor is not responsible for issuing an opinion on management's process for evaluating ICFR.

C. Definition of Material Weakness

1. Proposal

The Proposed Interpretive Guidance defined a material weakness as a deficiency, or combination of deficiencies, in ICFR such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis by the company's ICFR. Further, we indicated that the definition formulated in the proposal was intended to be consistent with its use in existing auditing literature and practice.³⁴

2. Comments on the Proposal

Commenters expressed concern about differences between our proposed definition of material weakness and that proposed by the PCAOB in its Proposed Auditing Standard and requested that the two definitions be aligned.³⁵ Commenters also suggested that a single definition of material weakness be established for use by both auditors and management. They further thought that we should codify the definition in our rules.³⁶

In addition, commenters pointed out that while the Proposed Interpretive Guidance referred to significant deficiencies, the Commission did not include a definition

³⁴ The PCAOB's Proposed Auditing Standard provided the following definition of material weakness: "a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected."

³⁵ See, for example, letters from Edison Electric Institute (EEI), FEI CCR, Financial Executives International Small Public Company Task Force (FEI SPCTF), The Institute of Chartered Accountants in England and Wales (ICAEW), Nina Stofberg, and SVLG.

³⁶ See, for example, letters from FEE and ICAEW.

of significant deficiency within the Proposed Interpretive Guidance.³⁷ Despite the fact that the Proposed Interpretive Guidance did not include a definition of significant deficiency, commenters on this topic provided feedback about both the Commission’s proposed definition of material weakness and the definition of significant deficiency as proposed by the PCAOB.³⁸ Certain commenters indicated that the Commission should include a definition of significant deficiency in the Interpretive Guidance.³⁹

Commenters also provided feedback on the probability language in the definition of material weakness. Commenters expressing support for the “reasonable possibility” standard in the proposed definition⁴⁰ noted that this language improves the clarity of the existing definition and will reduce time spent evaluating deficiencies.⁴¹ In contrast, other commenters felt that the probability standard should be changed.⁴² These commenters noted that the meaning of “reasonably possible” was the same as “more than remote” and therefore would not reduce the effort devoted to identifying and analyzing deficiencies. Two of these commenters suggested the Commission use a “reasonable likelihood”

³⁷ See, for example, letters from Cardinal Health, Inc. (Cardinal), EEI, and Protiviti.

³⁸ The PCAOB’s Proposed Auditing Standard provided the following definition of significant deficiency: “a control deficiency, or combination of control deficiencies, such that there is a reasonable possibility that a significant misstatement of the company's annual or interim financial statements will not be prevented or detected.” A significant misstatement was defined as “a misstatement that is less than material yet important enough to merit attention by those responsible for oversight of the company's financial reporting.”

³⁹ See, for example, letters from Cardinal and Protiviti.

⁴⁰ See, for example, letters from Cisco, FEI CCR, Hudson, MetLife, MSFT, and P&G.

⁴¹ See, for example, letters from Cisco, Committee on Capital Markets Regulation (CCMR), FEI SPCTF, Hudson, MetLife, MSFT, Nike, P&G, and TechNet.

⁴² See, for example, letters from the American Bar Association’s Committees on Federal Regulation of Securities and Law and Accounting of the Section of Business Law (ABA), ACCA, Cardinal Health, Inc., Chamber, CSC, IIA, Kimball, and NYC Bar.

standard,⁴³ and another suggested the Commission change to a “greater than fifty-percent” standard.⁴⁴ Commenters also requested additional guidance about how the concept of “materiality” impacted the definition.⁴⁵

Most of the commenters who addressed the reference to interim financial statements in the definition of material weakness indicated that the word “interim” should be removed from the definition,⁴⁶ with only one commenter expressing the view that the reference to interim financial statements should remain in the definition.⁴⁷ Some commenters who suggested removal of “interim” expressed the view that because Section 404 of Sarbanes-Oxley mandates an annual assessment of ICFR, the deficiency evaluation should also be based on the impact to the annual financial statements. Others stated that the removal of “interim” would allow management and auditors to better focus on the annual financial statements when evaluating the materiality of control deficiencies.

3. Final Rule

After consideration of the comments received, we have determined that it is appropriate for the Commission’s rules to include the definition of material weakness since it is an integral term associated with Sarbanes-Oxley and the Commission’s implementing rules. Management’s disclosure requirements with respect to ICFR are predicated upon the existence of a material weakness; therefore, we agree with the commenters’ suggestion that our rules should define this term, rather than refer to

⁴³ See letters from NYC Bar and Cleary.

⁴⁴ See letter from ABA.

⁴⁵ See, for example, letters from ABA, CCMR, CSC, Independent Community Bankers of America, ISACA and IT Governance Institute, P&G, and Rockwood Holdings, Inc.

⁴⁶ See, for example, letters from ABA, Cisco, Deloitte & Touche LLP, EEI, Eli Lilly, FEI CCR, FEI SPCTF, Ford Motor Company, MSFT, P&G, and PPL.

⁴⁷ See letter from MetLife.

auditing literature. As a result, we are amending Exchange Act Rule 12b-2 and Rule 1-02 of Regulation S-X to define the term material weakness.

We have decided to adopt the material weakness definition substantially as proposed. The Commission has determined that the proposed material weakness definition appropriately describes those conditions in ICFR that, if they exist, should be disclosed to investors and should preclude a conclusion that ICFR is effective. Therefore, our final rules define a material weakness as a deficiency, or a combination of deficiencies, in ICFR such that there is a reasonable possibility that a material misstatement of the registrant's annual or interim financial statements will not be prevented or detected on a timely basis.⁴⁸ We anticipate that the PCAOB's auditing standards will also include this definition of material weakness.

After consideration of the proposed alternatives to the "reasonable possibility" standard in the proposed definition of material weakness, we decided not to change the proposed standard. Revisions that have the effect of increasing the likelihood (that is, risk) of a material misstatement in a company's financial reports that can exist before being disclosed could give rise to questions about the meaning of a disclosure that ICFR is effective and whether the threshold for "reasonable assurance" is being lowered. Moreover, we do not believe improvements in efficiency arising from revisions to the likelihood element would be significant to the overall ICFR evaluation effort, due, in part, to our view that the effort evaluating deficiencies would be similar under the alternative standards (for example, "reasonable possibility" as compared to "reasonable likelihood"). Lastly, we do not believe the volume of material weakness disclosures,

⁴⁸ Exchange Act Rule 12b-2 and Rule 1-02(p) of Regulation S-X.

which has declined each year since the initial implementation of Section 404 of Sarbanes-Oxley, is too high such that investors would benefit from a reduction in disclosures that would result from a higher likelihood threshold.

Regarding the reference to interim financial statements in the definition of material weakness, while we believe annual materiality considerations are appropriate when making judgments about the nature and extent of evaluation procedures, we believe that the judgments about whether a control is adequately designed or operating effectively should consider the requirement to provide investors reliable annual and quarterly financial reports. Moreover, if management's annual evaluation identifies a deficiency that poses a reasonable possibility of a material misstatement in the company's quarterly reports, we believe management should disclose the deficiency to investors and not assess ICFR as effective. As such, we have not removed the reference to interim financial statements from the definition of material weakness.

In response to the comments regarding the need for the Commission to define the term "significant deficiency," we are seeking additional comment on a definition of that term as part of a separate release issued in the Federal Register.

III. TRANSITION ISSUES

Although the amendments to Rules 1-02 and 2-02 of Regulation S-X will no longer require the auditor to separately express an opinion concerning management's assessment of the effectiveness of the company's ICFR, audits conducted under AS No. 2 will continue to result in a separate opinion on management's assessment until the PCAOB's expected new auditing standard replacing AS No. 2 becomes effective and is required for all audits. Until such time, companies may file whichever report they

receive from their independent auditor (that is, either one that contains both opinions under AS No. 2 or the single opinion under the expected new auditing standard).

IV. BACKGROUND TO REGULATORY ANALYSES

Congress enacted the Sarbanes-Oxley Act in July 2002. Section 404 of the Act directed the Commission to prescribe rules requiring each issuer required to file an annual report under Section 13(a) or 15(d) of the Exchange Act⁴⁹ to prepare an internal control report. The only Exchange Act reporting companies that Congress exempted from the Section 404 requirements were investment companies registered under Section 8 of the Investment Company Act.⁵⁰

To fulfill its statutory mandate, the Commission adopted rules in June 2003 to require all Exchange Act reporting companies other than registered investment companies, regardless of their size, to include in their annual reports a report of management, and an accompanying auditor's report, on the effectiveness of the company's internal control over financial reporting ("ICFR").⁵¹

Although the Commission adopted rules in 2003 creating the obligation for all reporting companies to include ICFR reports in their annual reports, it provided a lengthy compliance period for non-accelerated filers, which are smaller public companies with a public float below \$75 million.⁵² Under the compliance dates that the Commission

⁴⁹ 15 U.S.C. 78m or 78o(d).

⁵⁰ 15 U.S.C. 80a-8.

⁵¹ Release No. 33-8238 (June 5, 2003) [68 FR 36636].

⁵² Although the term "non-accelerated filer" is not defined in Commission rules, we use it to refer to an Exchange Act reporting company that does not meet the Exchange Act Rule 12b-2 definition of either an "accelerated filer" or a "large accelerated filer."

originally established, non-accelerated filers would not have become subject to the ICFR requirements until they filed an annual report for a fiscal year ending on or after April 15, 2005. In contrast, accelerated filers and large accelerated filers – companies with a public float of \$75 million or more – became subject to the Section 404 requirements with respect to annual reports that they filed for fiscal years ending on or after November 15, 2004.

The Commission provided this lengthy compliance period for non-accelerated filers in light of both the substantial time and resources needed by accelerated filers to properly implement the rules. In addition, it believed that a corresponding benefit to investors would result from an extended transition period that allowed companies to carefully implement the new requirements. After each of the first two years accelerated filers implemented the Section 404 requirements, the Commission held a roundtable discussion, and solicited comment on issues that arose during implementation.⁵³

Since the initial extension period, the Commission has further extended the compliance dates for non-accelerated filers. The Commission adopted the most recent compliance date extension for non-accelerated filers in December 2006.⁵⁴ This extension was based, in part, on a recommendation from the Commission’s Advisory Committee on Smaller Public Companies (“Advisory Committee”). In its Final Report, issued on April 23, 2006, the Advisory Committee raised a number of concerns regarding the ability of smaller companies to comply cost-effectively with the requirements of Section 404. The

⁵³ As a result of which, the Commission and its staff issued guidance to assist companies in implementing these requirements.

⁵⁴ Release No. 33-8760 (Dec. 15, 2006) [71 FR 77635].

Advisory Committee identified as an overarching concern the difference in how smaller and larger public companies operate.

It focused in particular on three characteristics: (1) the limited number of personnel in smaller companies, which constrains the companies' ability to segregate conflicting duties; (2) top management's wider span of control and more direct channels of communication, which increase the risk of management override; and (3) the dynamic and evolving nature of smaller companies, which limits their ability to have static processes that are well-documented.⁵⁵

The Advisory Committee suggested that these characteristics create unique differences in how smaller companies achieve effective ICFR that may not be adequately accommodated in Auditing Standard No. 2 or other implementation guidance as currently applied in practice. In addition, the Advisory Committee noted serious ramifications for smaller public companies stemming from the cost of frequent documentation changes and sustained review and testing of controls perceived to be necessary to comply with the Section 404 requirements.

The Commission also granted the December 2006 extension in view of a series of actions that the Commission and the PCAOB each announced on May 17, 2006 that they intended to take to improve the implementation of the Section 404 requirements. These actions included:

⁵⁵ Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission (Apr. 23, 2006) ("Advisory Committee Report") available at <http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf>.

- Issuance of a Concept Release soliciting comment on a variety of issues that might be included in future Commission guidance for management to assist in its performance of a top-down, risk-based assessment of ICFR;
- Consideration of additional guidance from COSO on understanding and applying the COSO framework;⁵⁶
- Revisions to Auditing Standard No. 2;
- Reinforcement of auditor efficiency through PCAOB inspections and Commission oversight of the PCAOB's audit firm inspection program;
- Development, or facilitation of development, of implementation guidance for auditors of smaller public companies; and
- Continuation of PCAOB forums on auditing in the small business environment.

Pursuant to the most recent extension of the compliance dates, non-accelerated filers are scheduled to begin including a management report on ICFR in their annual reports filed for a fiscal year ending on or after December 15, 2007, and an auditor's report on ICFR for a fiscal year ending on or after December 15, 2008. It was our intention that non-accelerated filers would be able to complete their assessment of internal control without engaging an independent auditor during the first year. In addition, to eliminate second-guessing of management that might result from separating the management and auditor reports, the rules provide that the management report

⁵⁶ On July 11, 2006, COSO issued guidance entitled "Internal Control Over Financial Reporting - Guidance for Smaller Public Companies" that was designed primarily to help management of smaller public companies with establishing and maintaining effective ICFR.

included in a non-accelerated filer's annual report during the first year of compliance is deemed to be "furnished" rather than "filed."⁵⁷

The December 2006 extension of the management report requirement was intended to provide the non-accelerated filers with the benefit of both the Commission's management guidance and the COSO guidance for smaller companies before planning and conducting their initial ICFR assessments. The extension of the auditor report requirement was intended to:

- Afford non-accelerated filers and their auditors the benefit of anticipated changes to the PCAOB's Auditing Standard No. 2, and any implementation guidance issued by the PCAOB for auditors of non-accelerated filers;
- Save non-accelerated filers the costs of the auditor attestation to, and report on, management's initial assessment of ICFR;
- Enable management of non-accelerated filers to more gradually prepare for full compliance with the Section 404 requirements and to gain some efficiencies in the process of reviewing and evaluating the effectiveness of ICFR before becoming subject to the requirement that the auditor report on ICFR (and to permit investors to see and evaluate the results of management's first compliance efforts); and
- Provide the Commission with the flexibility to consider any comments it received on the Concept Release and the proposed guidance for

⁵⁷ Management's report is not deemed to be filed for purposes of Section 18 of the Exchange Act [15 U.S.C. 78r] or otherwise subject to the liabilities of that section, unless the issuer specifically states that the report is to be considered "filed" under the Exchange Act or incorporates it by reference into a filing under the Securities Act or the Exchange Act.

management in response to questions related to the appropriate role of the auditor in evaluating management's internal control assessment process.

On July 11, 2006, we issued a Concept Release to seek public comment on the issues to be addressed in our guidance for management on how to assess ICFR.⁵⁸ The Commission received approximately 167 comment letters in response to the Concept Release, a majority of which supported additional Commission guidance to management that is applicable to companies of all sizes and complexities. The Commission considered the feedback received in those comment letters in drafting its Interpretive Guidance.

In conjunction with issuance of the Interpretive Guidance, in this release we are adopting amendments to the existing requirements of Exchange Act Rules 13a-15(c) and 15d-15(c) that management of each company subject to the Exchange Act periodic reporting requirements evaluate, as of the end of each fiscal year, the effectiveness of the company's ICFR. The amendments state that an evaluation that complies with the Interpretive Guidance will satisfy the annual evaluation requirement in Rules 13a-15(c) and 15d-15(c).

We are also adopting amendments to Rules 1-02 and 2-02 of Regulation S-X, and Item 308 of Regulations S-B and S-K, to state that the company's auditor must express only one opinion on a company's ICFR. This is a direct opinion by the auditor on the effectiveness of the company's ICFR. Prior to the amendments, auditors expressed two separate opinions: one on the effectiveness of a company's ICFR and another on management's assessment of the effectiveness of the company's ICFR. Finally, we are

⁵⁸ Release No. 34-54122 (July 11, 2006).

adopting an amendment to Exchange Act Rule 12b-2, and a corresponding amendment to Rule 1-02 of Regulation S-X, to define the term material weakness.

V. PAPERWORK REDUCTION ACT

Certain provisions of our ICFR requirements contain “collection of information” requirements within the meaning of the Paperwork Reduction Act of 1995 (“PRA”). We submitted these collections of information to the Office of Management and Budget (“OMB”) for review in accordance with the PRA and received approval for the collections of information. We do not believe the rule amendments in this release will impose any new recordkeeping or information collection requirements, or other collections of information requiring OMB’s approval.

VI. COST-BENEFIT ANALYSIS

The rule amendments and the Interpretive Guidance that we are adopting are intended to facilitate more effective and efficient evaluations of ICFR by management and auditors. Rules 13a-15 and 15d-15, as initially adopted, and as amended, do not mandate any specific method for management to follow in performing an evaluation of ICFR. Instead, the rules recognize that the methods of conducting evaluations of ICFR will, and should, vary from company to company. Commenters have asserted that the lack of specific direction in either Section 404 of the Sarbanes-Oxley Act or the implementing rules on how management should conduct an evaluation of ICFR may have resulted in the auditing standards becoming the de facto standard for management’s evaluation in many cases, which likely contributed to excessive documentation and testing of internal controls by management in initial compliance efforts.

The benefits and costs to investors of the rule amendments and Interpretive Guidance are directly related to the extent to which issuers choose to rely on the Interpretive Guidance. In part, this is because compliance is voluntary. In addition, companies already subject to the reporting requirement have gained some efficiencies in the evaluation process,⁵⁹ and other sources have provided guidance on how to conduct an ICFR evaluation.⁶⁰ The very purpose of the rule amendments and the Interpretive Guidance is to ease the compliance burden created by Section 404 of the Sarbanes-Oxley Act. Because of this, and because the use of Interpretive Guidance is voluntary, it is unlikely that it could result in additional incremental cost to issuers. Issuers that choose to use Interpretive Guidance will likely do so because it reduces their overall compliance burden.

A. Benefits

Our issuance of specific Interpretive Guidance for management on how to conduct an ICFR evaluation should significantly lessen the pressures on management to look to the auditing standards for guidance as to how to conduct its evaluation.⁶¹ To the extent that these pressures have led to excessive testing and documentation in the past, the Interpretive Guidance and rule amendments should lead management to avoid

⁵⁹ Commenters on the Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting, Release No. 34-54122 (Jul. 11, 2006) [71 FR 40866], available at <http://www.sec.gov/rules/concept/2006/34-54122.pdf>, expressed similar views. See, for example, letters from the American Institute of Certified Public Accountants, Crowe Chizek and Company LLC, and Kreisler Miller, all available at <http://www.sec.gov/comments/s7-11-06/s71106.shtml>.

⁶⁰ See, for example, The Institute of Internal Auditor's Sarbanes-Oxley Section 404: A Guide for Management by Internal Control Practitioners, May 2006.

⁶¹ We are taking this action in conjunction with the PCAOB's elimination of the auditor's requirement to evaluate the efficacy of management's evaluation process.

