

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 210, 228, 229 and 249

[RELEASE NOS. 33-8889; 34-57258; File No. S7-06-03]

RIN 3235-AJ64

**INTERNAL CONTROL OVER FINANCIAL REPORTING IN EXCHANGE ACT
PERIODIC REPORTS OF NON-ACCELERATED FILERS**

AGENCY: Securities and Exchange Commission.

ACTION: Proposed amendments of temporary rules.

SUMMARY: We are proposing to amend temporary rules that were published on December 21, 2006, in Release No. 33-8760 [71 FR 76580]. These temporary rules require companies that are non-accelerated filers to include in their annual reports, pursuant to rules implementing Section 404(b) of the Sarbanes-Oxley Act of 2002, an attestation report of their independent auditor on internal control over financial reporting for fiscal years ending on or after December 15, 2008. Under the proposed amendments, a non-accelerated filer would be required to provide the auditor's attestation report on internal control over financial reporting in an annual report filed for fiscal years ending on or after December 15, 2009.

DATES: Comments should be received on or before [insert date 30 days after date of publication in the Federal Register].

ADDRESSES: Comments may be submitted by any of the following methods:

Electronic Comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/other.shtml>);
- Send an e-mail to rule-comments@sec.gov. Please include File Number S7-06-03 on the subject line; or

- Use the Federal Rulemaking Portal (<http://www.regulations.gov>). Follow the instructions for submitting comments.

Paper Comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number S7-06-03. This file number should be included on the subject line if e-mail is used. To help us process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/other.shtml>). Comments are also available for public inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 am and 3:00 pm. All comments received will be posted without change; we do not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly.

FOR FURTHER INFORMATION CONTACT: Sean Harrison, Special Counsel, Office of Rulemaking, Division of Corporation Finance, at (202) 551-3430, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-3628.

SUPPLEMENTARY INFORMATION: We are proposing to amend the following forms and temporary rules: Rule 2-02T of Regulation S-X,¹ Item 308T of Regulation S-K,² and S-B,³ Item 4T of Form 10-Q,⁴ Item 3A(T) of Form 10-QSB,⁵ Item 9A(T) of Form 10-K,⁶ Item 8A(T) of

¹ 17 CFR 210-2.02T.

² 17 CFR 229.308T.

³ 17 CFR 228.310T.

⁴ 17 CFR 249.308a.

Form 10-KSB,⁷ Item 15T of Form 20-F,⁸ and Instruction 3T of General Instruction B.(6) of Form 40-F.⁹

I. BACKGROUND

On December 15, 2006,¹⁰ we extended the dates by which non-accelerated filers¹¹ must begin to comply with the internal control over financial reporting (“ICFR”) requirements mandated by Section 404 of the Sarbanes-Oxley Act of 2002.¹² Specifically, we postponed for five months, from fiscal years ending on or after July 15, 2007 to fiscal years ending on or after December 15, 2007, the date by which non-accelerated filers must begin to comply with the management report requirement in Item 308(a) of Regulation S-K.¹³ We also postponed to fiscal years ending on or after December 15, 2008 the date by which non-accelerated filers must begin to comply with the auditor attestation report requirement in Item 308(b) of Regulation S-K.¹⁴ We indicated that we would consider further postponing the auditor attestation report compliance

⁵ 17 CFR 249.308b.

⁶ 17 CFR 249.310.

⁷ 17 CFR 249.310(b).

⁸ 17 CFR 249.220f.

⁹ 17 CFR.249.240f.

¹⁰ See Release No. 33-8760 (December 15, 2006) [71 FR 76580] (the “2006 Release”).

¹¹ Although the term “non-accelerated filer” is not defined in our rules, we use it throughout this release to refer to an Exchange Act reporting company that does not meet the Rule 12b-2 definition of either an “accelerated filer” or a “large accelerated filer.”

¹² 15 U.S.C. 7262.

¹³ 17 CFR 229.308(a). We effected the postponement, in part, by adding temporary Item 308T to Regulation S-K. We similarly added temporary Item 308T to Regulation S-B, but the Commission recently adopted amendments that will eliminate Regulation S-B effective March 15, 2009. See Release No. 33-8876 (December 19, 2007) [73 FR 934].

¹⁴ 17 CFR 229.308(b).

date after considering the anticipated revisions to the Public Company Accounting Oversight Board's ("PCAOB") Auditing Standard No. 2 ("AS No. 2").

In the 2006 Release, we cited two primary reasons for deferring implementation of the auditor attestation report requirement for an additional year after implementation of the management report requirement. First, we stated that the deferred implementation would afford non-accelerated filers and their auditors the benefit of anticipated changes by the PCAOB to AS No. 2, subject to Commission approval, as well as any implementation guidance that the PCAOB issued for auditors of smaller public companies.

Second, we expected a deferred implementation of the auditor attestation requirement to save non-accelerated filers the full potential costs associated with the auditor's initial attestation to, and report on, management's assessment of ICFR during the period that changes to AS No. 2 were being considered and implemented, and the PCAOB was formulating guidance specifically for auditors of smaller public companies. Public commenters previously have asserted that the ICFR compliance costs are likely to be disproportionately higher for smaller public companies than larger ones, and that the auditor's fee represents a large percentage of those costs.¹⁵

Furthermore, we have learned from commenters, including those participating in our roundtables on implementation of the ICFR requirements, that while companies incur increased internal costs in the first year of compliance, some of which are due to "deferred maintenance" items (for example, documentation, remediation, etc.), these costs may decrease in the second year.¹⁶ Therefore, we anticipated that postponing the costs resulting from the auditor's

¹⁵ See, for example, letters of American Electronics Association, International Association of Small Broker-Dealers and Advisers, Small Business Entrepreneurship Council, and the Silicon Valley Leadership Group, Committee on Capital Markets Regulation on Release No. 33-8762 (December 20, 2006) [71 FR 77635], File No. S7-24-06.

¹⁶ Materials related to the Commission's 2005 Roundtable Discussion on Implementation of Internal Control Reporting Provisions and 2006 Roundtable on Second-Year Experiences with Internal Control Reporting and

attestation report until the second year would help non-accelerated filers to smooth the cost spike that many accelerated filers experienced in their first year of compliance with the Section 404 requirements.

The compliance date extensions that we granted in 2006 were part of a series of actions that the Commission and PCAOB each announced that they intended to take to improve implementation of the internal control over financial reporting requirements.¹⁷ These actions included:

- Issuance by the Commission of interpretive guidance for management to assist management in complying with the ICFR evaluation and disclosure requirements;
- Consideration of efforts by COSO to provide more guidance on how the COSO framework on internal control can be applied to smaller public companies;
- The PCAOB's issuance, with Commission approval, of Auditing Standard No. 5 ("AS No. 5"), which replaced AS 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.

Auditing Provisions, including the archived roundtable broadcasts, are available at <http://www.sec.gov/spotlight/soxcomp.htm>.

¹⁷ See SEC Press Release 2006-75 (May 17, 2006), "SEC Announces Next Steps for Sarbanes-Oxley Implementation" and PCAOB Press Release (May 17, 2006), "Board Announces Four-Point Plan to Improve Implementation of Internal Control Reporting Requirements."

On June 20, 2007, we approved the issuance of interpretive guidance¹⁸ and adopted rule amendments¹⁹ to help public companies strengthen their ICFR evaluations while reducing unnecessary costs. The interpretive release provided guidance for management on how to conduct an evaluation of the effectiveness of a company's ICFR. The guidance sets forth an approach by which management can conduct a top-down, risk-based evaluation of ICFR.

As discussed above, on July 25, 2007, we approved the PCAOB's AS No. 5, which replaced AS No. 2. The new standard sets forth the professional standards and related performance guidance for independent auditors to attest to, and report on, management's assessment of the effectiveness of ICFR. Our management guidance, in combination with AS No. 5, was intended to make ICFR audits and management evaluations of ICFR more cost-effective by being risk-based and scalable to a company's size and complexity. Although the PCAOB issued AS No. 5, and we approved it, according to our planned timetables, there still are some additional actions that the Commission and PCAOB intend to take that give us reason to propose a further extension of the auditor attestation report compliance date for non-accelerated filers.

One of these actions is the PCAOB's issuance of final staff guidance on auditing ICFR of smaller public companies. On October 17, 2007, the PCAOB published preliminary staff guidance that demonstrates how auditors can apply the principles described in AS No. 5 and provides examples of approaches to particular issues that might arise in the audits of smaller, less

¹⁸ Release No. 33-8810 (Jun. 20, 2007) [72 FR 35324].

¹⁹ Release No. 33-8809 (Jun. 20, 2007) [72 FR 35310]. The rule amendments, among other things, provided that an evaluation that complies with our interpretive guidance is one way to satisfy the annual ICFR evaluation requirement in Exchange Act Rules 13a-15(c) and 15d-15(c) [17 CFR 240.13a-15(c) and 240.15d-15(c)].

complex public companies.²⁰ Topics discussed in the PCAOB's guidance include: entity-level controls, risk of management override, segregation of duties and alternative controls, information technology controls, financial reporting competencies, and testing controls with less formal documentation. The PCAOB sought public comment on this guidance, and the comment period ended on December 17, 2007.²¹

Another action involves a study that we are undertaking to determine whether the Section 404(b) auditor attestation requirement of the Sarbanes-Oxley Act is being implemented in a manner that will be cost-effective for smaller reporting companies. The study will pay special attention to those small companies that are complying with the ICFR requirements for the first time.

This study of costs and benefits will include a web-based survey of companies that are subject to the ICFR requirements as well as in-depth interviews with a subset of these companies. Our plan is to gather data from a large cross-section of companies about the costs and benefits of compliance with the ICFR requirements and to evaluate whether the new management guidance and AS No. 5 are having the intended effect of facilitating more cost-effective ICFR evaluations and audits. Because we intend to collect data based on companies' experiences, this study will be taking place in the coming months as companies for the first time prepare their financial statements and undergo external audits under the new AS No. 5 and/or conduct their internal ICFR evaluations with the aid of the new management guidance. We anticipate that the study and analysis of the results will be completed no earlier than the summer of 2008.

²⁰ See "An Audit of Internal Control that is Integrated with an Audit of the Financial Statements: Guidance for Auditors of Smaller Companies," (October 17, 2007), available at www.pcaobus.org.

²¹ The PCAOB has not announced when it plans to finalize this guidance.

We also note that others have expressed concerns about the orderly and efficient implementation of the ICFR requirements.²²

If we do not adopt the proposed amendments, non-accelerated filers will have to begin complying with the auditor attestation requirement for fiscal years ending on or after December 15, 2008. To accomplish this, in 2008, many non-accelerated filers would need to engage their independent auditors to perform integrated audits of their financial statements and ICFR.

Without an extension, these companies may begin to incur costs before we have an opportunity to observe whether further action to improve the effectiveness and efficiency of Section 404 implementation is warranted. Therefore, we believe that an additional one-year deferral of the auditor attestation requirement would be appropriate so that these companies do not incur unnecessary compliance costs before we have the benefit of the study. An additional one-year deferral will allow the PCAOB additional time during 2008 to promulgate its guidance for ICFR audits of smaller public companies, as well as additional time for the auditors of non-accelerated filers to incorporate such guidance in their planning and conduct of their ICFR audits during 2009.

II. PROPOSED EXTENSION OF AUDITOR ATTESTATION COMPLIANCE DATE FOR NON-ACCELERATED FILERS

We propose to amend Item 308T of Regulation S-K, Rule 2-02T of Regulation S-X, and Forms 10-Q, 10-K, 20-F and 40-F to require non-accelerated filers to provide their auditor's attestation in their annual reports filed for fiscal years ending on or after December 15, 2009. If

²² See, for example, the May 8, 2007, letter to Chairman Christopher Cox and Chairman Mark Olson from Senator John Kerry, Chairman, Senate Committee on Small Business and Entrepreneurship, and Senator Olympia Snowe, Ranking Member, Senate Committee on Small Business and Entrepreneurship, available at <http://sbc.senate.gov/lettersout/070508-SEC-PCAOB-HearingFollowUp.pdf>; hearing on "Sarbanes-Oxley Section 404: New Evidence on the Costs for Small Businesses," House Committee on Small Business (December 12, 2007); and the July 12, 2007, letter from Sharon Haeger, America's Community Bankers, on Release No. 34-55876 [72 FR 32340], File No. PCAOB 2007-02, available at <http://www.sec.gov/comments/pcaob-2007-02/pcaob200702.shtml>.

we adopt the proposed amendments, a non-accelerated filer would continue to be required to state in its management report on ICFR that the company's annual report does not include an auditor attestation report.²³

In the 2006 Release, we also adopted a temporary amendment that provided that the management report included in a non-accelerated filer's annual report that did not contain the auditor's attestation report would be deemed "furnished" rather than "filed" and not be subject to liability under Section 18 of the Exchange Act.²⁴ We acknowledged in that release non-accelerated filers filing only a management report during their first year of compliance with the Section 404(a) requirements may become subject to more second-guessing as a result of separating the management report from the auditor's attestation. As proposed, the amendments would maintain this distinction.

Request for Comment

We request and encourage any interested person to submit comments regarding the proposed amendments to extend the auditor attestation report compliance date described above.

In particular, we solicit comment on the following questions:

- Is it appropriate to provide a further extension of the auditor attestation requirement for non-accelerated filers as proposed? If so, should we postpone this requirement for an additional year as proposed, or would a longer or shorter timeframe be more appropriate?

²³ See Item 308T(a)(4) of Regulation S-K, Item 15T(b)(4) of Form 20-F and General Instruction B.(6)(3T) of Form 40-F.

²⁴ Section 18 of the Exchange Act [15 U.S.C. 78r] imposes liability on any person who makes or causes to be made in any application or report or document filed under the Act, or any rule thereunder, any statement that "was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact." As a result of the temporary Item 308T of Regulation S-K and S-B and the temporary amendments to Forms 20-F and 40-F, however, during the applicable periods, management's report would be subject to liability under this section only in the event that a non-accelerated filer 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.

- How would the proposed extension affect investors in non-accelerated filers?
- Would the proposed additional deferral of the auditor’s attestation report requirement make the application of the Section 404 requirements more or less efficient and effective for non-accelerated filers?
- Should management’s report on ICFR be “filed” rather than “furnished” during the second year of the non-accelerated filer’s compliance with the ICFR requirements under Section 404(a) if we adopt the proposed extension?

III. PAPERWORK REDUCTION ACT

In connection with our original proposal and adoption of the rules and amendments implementing the Section 404 requirements, we submitted cost and burden estimates of the collection of information requirements of the amendments to the Office of Management and Budget (“OMB”). We published a notice requesting comment on the collection of information requirements in the proposing release for the rule amendments. We submitted these requirements to the OMB for review in accordance with the Paperwork Reduction Act of 1995 (“PRA”)²⁵ and received approval of these estimates. We do not believe that the proposed extension will result in any change in the collection of information requirements of the amendments implementing Section 404. Therefore, we are not revising our PRA burden and cost estimates submitted to the OMB.

IV. COST-BENEFIT ANALYSIS

A. Benefits

The proposed amendments would postpone for one year the date by which a non-accelerated filer would be required to include in its annual report an auditor attestation report on

²⁵ 44 U.S.C. 3501 et seq. and 5 CFR 1320.11.

management's assessment of internal control over financial reporting. As a result, all non-accelerated filers would be required to complete only management's assessment in their first and second year of their compliance with the Section 404 requirements.

We plan to conduct a study to assess whether the Section 404(b) auditor attestation requirement of the Sarbanes-Oxley Act is being implemented in a manner that will be cost-effective for smaller reporting companies. Our management guidance and the new auditing standard were designed to make management evaluations and ICFR audits more cost-effective. We believe that an additional one-year deferral of the auditor attestation report requirement would benefit non-accelerated filers by helping smaller companies avoid incurring unnecessary compliance costs as we determine whether further action to improve the effectiveness and efficiency of Section 404 implementation is warranted. In addition, we believe that non-accelerated filers may experience the following additional benefits from the proposed extension:

- Auditors of non-accelerated filers would have significantly more time to conform their ICFR audit approach to meet the requirements of AS No. 5, and to consider the PCAOB's guidance for auditors of smaller public companies; and
- Non-accelerated filers would have additional time to focus on their approach for evaluating and reporting on the effectiveness of ICFR. This may facilitate their efforts to develop best practices and efficiencies in preparing the management report prior to becoming subject to the auditor attestation report requirement.

B. Costs

If we adopt the proposed amendments, investors in non-accelerated filers will have to wait longer than they would in the absence of the proposed extension for the assurances provided by the attestation report by the companies' auditor on management's report on ICFR and the

added investor confidence that could result. The proposed amendments may increase the risk that, without the auditor’s attestation, some non-accelerated filers may erroneously conclude that the company’s ICFR is effective, when an ICFR audit might reveal that it is not. In addition, some companies may conduct an assessment that is not as thorough, careful and as appropriate to the company’s circumstances as they would perform if the auditor were also conducting an audit of ICFR. The proposed amendments may also increase the risk that weaknesses in a company’s ICFR will go undetected for a longer period of time.

We request data to quantify the potential costs and benefits described above. We seek estimates of these costs and benefits, as well as any costs and benefits that we have not identified that may result from the adoption of these proposed amendments. We also request qualitative feedback on the nature of the potential benefits and costs described above and any benefits and costs we may have overlooked.

V. CONSIDERATION OF IMPACT ON THE ECONOMY, BURDEN ON COMPETITION AND PROMOTION OF EFFICIENCY, COMPETITION AND CAPITAL FORMATION

For purposes of the Small Business Regulatory Enforcement Fairness Act of 1996, or “SBREFA,”²⁶ we solicit data to determine whether the proposals constitute a “major” rule.

Under SBREFA, a rule is considered “major” where, if adopted, it results or is likely to result in:

- An annual effect on the economy of \$100 million or more (either in the form of an increase or a decrease);
- A major increase in costs or prices for consumers or individual industries; or
- Significant adverse effects on competition, investment or innovation.

²⁶ 5 U.S.C. 603.

We request comment on the potential impact of the proposals on the economy on an annual basis. Commenters are requested to provide empirical data and other factual support for their views if possible.

Section 23(a)(2) of the Exchange Act²⁷ also requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. 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. In addition, Section 2(b)²⁸ of the Securities Act and Section 3(f)²⁹ of the Exchange Act require us, when engaging in rulemaking where we are required to consider or determine whether an action is necessary or appropriate in the public interest, to also consider whether the action will promote efficiency, competition, and capital formation.

We believe that taking additional time to evaluate how efficiently the Section 404(b) process is being implemented reduces the possibilities of needless inefficiencies and transition costs for non-accelerated filers. Further, if the costs incurred by companies are unnecessarily high, companies may find it difficult to grow and may experience barriers to capital formation. We expect that this additional one-year delay of the auditor attestation report requirement will make the implementation process more efficient and less costly for non-accelerated filers, which should promote efficiency and capital formation.

It is possible that a competitive impact could result from the differing treatment of non-accelerated filers and larger companies that already have been complying with the Section 404

²⁷ 15 U.S.C. 78w(a).

²⁸ 15 U.S.C. 77b(b).

²⁹ 15 U.S.C. 78c(f).

requirements, but we do not expect that the extension will have any measurable effect on competition. We solicit public comment that will assist us in assessing the impact that the proposed amendments could have on competition, efficiency and capital formation.

VI. INITIAL REGULATORY FLEXIBILITY ANALYSIS

This Initial Regulatory Flexibility Analysis (“IRFA”) has been prepared in accordance with the Regulatory Flexibility Act.³⁰ This IRFA involves proposed amendments to temporary rules Item 308T of Regulation S-K and S-B, Rule 2-02T of Regulation S-X, Item 4T of Form 10-Q, Item 3A(T) of Form 10-QSB, Item 9A(T) of Form 10-K, Item 8A(T) of Form 10-KSB, Item 15T of Form 20-F, and Instruction 3T of General Instruction B.(6) of Form 40-F. A non-accelerated filer is currently required to start providing its auditor’s attestation report on ICFR in its annual report for fiscal years ending on or after December 15, 2008. We propose to amend these forms and temporary rules to require a non-accelerated filer to start providing its auditor’s attestation report on ICFR in annual reports for fiscal years ending on or after December 15, 2009.

A. Reasons for the Proposed Amendments

The Commission plans to complete a study of the costs and benefits of companies’ Section 404 implementation. We are proposing to defer the implementation of the auditor attestation report requirement for non-accelerated filers for an additional year for the following reasons, among others discussed above:

- To enable non-accelerated filers more time to prepare and gain efficiencies in the review and evaluation of the effectiveness of internal control over financial reporting;

³⁰ 5 U.S.C. 601.

- To provide the Commission with time to review the findings of its study and to consider whether further action to improve the effectiveness and efficiency of Section 404 implementation is warranted;
- To provide the PCAOB additional time to promulgate its guidance for ICFR audits of smaller public companies; and
- To provide the auditors of non-accelerated filers additional time to consider such guidance.

B. Objectives

The proposed amendments aim to further the goals of the Sarbanes-Oxley Act to enhance the quality of public company disclosure concerning the company's internal control over financial reporting and increase investor confidence in the financial markets.

C. Legal Basis

We are issuing the proposals under the authority set forth in Section 19 of the Securities Act, Sections 3, 12, 13, 15, 23 and 36 of the Exchange Act, and Sections 3(a) and 404 of the Sarbanes-Oxley Act.

D. Small Entities Subject to the Proposed Amendments

The proposed changes would affect some issuers that are small entities. Exchange Act Rule 0-10(a)³¹ 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 1,100 issuers, other than registered investment companies, that may be considered small entities. The proposed amendments would

³¹ 17 CFR 240.0-10(a).

