

“a Hobson’s choice” of violating the TSR or failing to deliver “medically necessary prerecorded messages,” and that “[n]either choice makes any sense.”<sup>10</sup> Similarly, the Silverlink petition argues that if an extension is not granted, patients would be deprived of calls that improve healthcare services and patient outcomes.<sup>11</sup>

The Commission rejects DMA’s argument that revoking its previously announced non-enforcement policy can reasonably be seen as in any way prejudging the outcome of the amendment proceeding. Nevertheless, in recognition of the reasons presented by the petitions and in order to preserve the *status quo*, the Commission has determined that, pending completion of this proceeding, the Commission will continue “to forbear from bringing any enforcement action for violation of the TSR’s call abandonment prohibition, 16 CFR 310.4(b)(1)(iv), against a seller or telemarketer that places telephone calls to deliver prerecorded telemarketing messages to consumers with whom the seller on whose behalf the telemarketing call is placed has an established business relationship, as defined in the TSR, provided the seller or telemarketer conducts this activity in conformity with the [following] terms:”<sup>12</sup>

- (i) The seller or telemarketer, for each such telemarketing call placed, allows the telephone to ring for at least fifteen (15) seconds or four (4) rings before disconnecting an unanswered call;

- (ii) Within two (2) seconds after the person’s completed greeting, the seller or telemarketer promptly plays a prerecorded message that:

- (A) Presents an opportunity to assert an entity-specific Do Not Call request pursuant to § 310.4(b)(1)(iii)(A) at the outset of the message, with only the prompt disclosures required by § 310.4(d) or (e) preceding such opportunity; and

- (B) Complies with all other requirements of this Part [16 CFR Part 310] and other applicable federal and state laws.”<sup>13</sup>

The Commission has stated its belief that, as the foregoing criteria indicate, “an interactive feature (pressing a button during the message to connect to a sales representative or an automated system to make a Do Not Call request) would be ideal . . . to protect consumers’ Do Not Call rights under the TSR.”<sup>14</sup> The Commission emphasizes that its forbearance policy applies only

to prerecorded telemarketing calls that comply completely with all of the foregoing criteria.

By direction of the Commission.

**Donald S. Clark,**

*Secretary.*

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## SECURITIES AND EXCHANGE COMMISSION

### 17 CFR Parts 210, 240 and 241

[Release Nos. 33–8762; 34–54976; File No. S7–24–06]

RIN 3235–AJ58

#### Management’s Report on Internal Control Over Financial Reporting

**AGENCY:** Securities and Exchange Commission.

**ACTION:** Proposed interpretation; Proposed rule.

**SUMMARY:** We are proposing interpretive guidance for management regarding its evaluation of internal control over financial reporting. The interpretive guidance sets forth an approach by which management can conduct a top-down, risk-based evaluation of internal control over financial reporting. The proposed guidance is intended to assist companies of all sizes to complete their annual evaluation in an effective and efficient manner and it provides guidance on a number of areas commonly cited as concerns over the past two years. In addition, we are proposing an amendment to our rules requiring management’s annual evaluation of internal control over financial reporting to make it clear that an evaluation that complies with the interpretive guidance is one way to satisfy those rules. Further, we are proposing an amendment to our rules to revise the requirements regarding the auditor’s attestation report on the assessment of internal control over financial reporting.

**DATES:** *Comment Date:* Comments should be received on or before February 26, 2007.

**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/proposed.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number S7–24–06 on the subject line; or

- Use the Federal eRulemaking 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 S7–24–06. 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/proposed.shtml>). Comments are also available for public inspection and copying in the Commission’s Public Reference Room, 100 F Street, NE., Washington, DC 20549. 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:** Michael G. Gaynor, Professional Accounting Fellow, Office of the Chief Accountant, at (202) 551–5300, or N. Sean Harrison, Special Counsel, Division of Corporation Finance, at (202) 551–3430 U.S. Securities and Exchange Commission, 100 F Street, NE., Washington, DC 20549.

**SUPPLEMENTARY INFORMATION:** We are proposing amendments to Rule 13a–15(c),<sup>1</sup> and Rule 15d–15(c)<sup>2</sup> under the Securities Exchange Act of 1934 (the “Exchange Act”);<sup>3</sup> and Rules 1–02(a)(2)<sup>4</sup> and 2–02(f)<sup>5</sup> of Regulation S–X.<sup>6</sup>

#### I. Background

Section 404(a) of the Sarbanes-Oxley Act of 2002<sup>7</sup> (“Sarbanes-Oxley”) directed the Commission to prescribe rules that require each annual report that a company, other than a registered investment company, files pursuant to Section 13(a) or 15(d)<sup>8</sup> 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

<sup>10</sup> medSage petition at 4.

<sup>11</sup> Silverlink petition at 6–7 & nn.14–16.

<sup>12</sup> 69 FR 67287, 67290 (Nov. 17, 2004).

<sup>13</sup> 69 FR at 67294 (noting that “This provision does not affect any seller’s or telemarketer’s obligation to comply with relevant state and federal laws, including but not limited to the TCPA, 47 U.S.C. 227, and 47 CFR part 64.1200.”)

<sup>14</sup> 69 FR 67289.

<sup>1</sup> 17 CFR 240.13a–15(c).

<sup>2</sup> 17 CFR 240.15d–15(c).

<sup>3</sup> 15 U.S.C. 78a *et seq.*

<sup>4</sup> 17 CFR 210.1–02.

<sup>5</sup> 17 CFR 210.2–02(f).

<sup>6</sup> 17 CFR 210.1–01 *et seq.*

<sup>7</sup> 15 U.S.C. 7262.

<sup>8</sup> 15 U.S.C. 78m(a) or 78o(d).

end of the company's most recent fiscal year, of the effectiveness of the company's internal control structure and procedures for financial reporting. On June 5, 2003, the Commission adopted rules implementing Section 404 with regard to management's obligations to report on its internal control structure and procedures and, in so doing, created the term "internal control over financial reporting" ("ICFR").<sup>9</sup>

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").<sup>10</sup> The significance of Section 404 of Sarbanes-Oxley is that it re-emphasizes the important relationship between the maintenance of effective ICFR and the preparation of reliable financial statements. Effective ICFR can also help companies deter fraudulent financial accounting practices or detect them earlier and perhaps reduce their adverse effects. While controls are susceptible to manipulation, especially in instances of fraud involving the collusion of two or more people, including senior management, these are known limitations of internal control systems. Therefore, it is possible to design ICFR to reduce, though not eliminate, instances of fraud.

When the Commission adopted rules in June 2003 to implement Section 404 of Sarbanes-Oxley, we emphasized two broad principles: (1) That the evaluation

<sup>9</sup> See Release No. 33-8238 (June 5, 2003) [68 FR 36636] (hereinafter the "Adopting Release"). See Release No. 33-8392 (February 24, 2004) [69 FR 9722] for compliance dates applicable to accelerated filers. See Release No. 33-8760 (December 15, 2006) for compliance dates applicable to non-accelerated filers.

<sup>10</sup> Title I of Pub. L. 95-213 (1977). 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 (a) 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; and (b) 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 (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;

(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.

The definition of internal control over financial reporting is consistent with the description of internal accounting controls under the FCPA.

must be based on procedures sufficient both to evaluate the design and to test the operating effectiveness<sup>11</sup> of ICFR; and (2) that the assessment, including testing, must be supported by reasonable evidential matter.<sup>12</sup> Instead of providing specific guidance regarding the evaluation, we expressed our belief that the methods of conducting evaluations of ICFR will, and should, vary from company to company and will depend on the circumstances of the company and the significance of the controls.<sup>13</sup> We continue to believe that it is impractical to prescribe a single methodology that meets the needs of every company.

Since the Commission first adopted the ICFR requirements, companies and third parties have devoted considerable attention to the methods that management may use to evaluate ICFR. Efforts to comply with the Commission's rules have resulted in many public companies internally developing their own evaluation processes, while other companies have retained consultants or purchased commercial software and other products to establish or improve their ICFR evaluation process.<sup>14</sup> Management must bring its own experience and informed judgment to bear in order to design an evaluation process that meets the needs of its company and that provides reasonable assurance for its assessment. This proposed guidance is intended to allow management the flexibility to design such an evaluation process.

In order to facilitate the comparability of the assessment reports among companies, our rules implementing Section 404 require management to base its assessment of a company's internal control on a suitable evaluation framework. While the establishment and maintenance of internal accounting controls have been required since the enactment of the FCPA, as discussed above, the Commission's rules implementing Section 404 required

<sup>11</sup> See Adopting Release at Section II.B.3.d.

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> Exchange Act Rules 13a-15 and 15d-15 require management to evaluate the effectiveness of ICFR as of the end of the fiscal year. For purposes of this document, the term "evaluation" or "evaluation process" refers to the methods and procedures that management implements to comply with these rules. The term "assessment" is used in this document to describe the disclosure required by Item 308 of Regulations S-B and S-K [17 CFR 228.308 and 229.308]. This disclosure must include discussion of any material weaknesses which exist as of the end of the most recent fiscal year and management's assessment of the effectiveness of ICFR, including a statement as to whether or not ICFR is effective. Management is not permitted to conclude that ICFR is effective if there are one or more material weaknesses in ICFR.

management for the first time to use a framework for evaluating ICFR. It is important to note that our rules do not mandate the use of a particular framework, since multiple viable frameworks exist and others may be developed in the future. However, in the release adopting the Section 404 requirements, the Commission identified the *Internal Control—Integrated Framework* created by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") as an example of a suitable framework.<sup>15 16</sup>

While the COSO framework identifies the components and objectives of an effective system of internal control, it does not set forth an approach for management to follow in evaluating the effectiveness of a company's ICFR.<sup>17</sup> We, therefore, distinguish between the COSO framework as a definition of what constitutes an effective system of internal control and guidance on how to evaluate ICFR for purposes of our rules. The guidance that we are proposing in

<sup>15</sup> See COSO, *Internal Control-Integrated Framework* (1992). 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.

The COSO framework is the result of an extensive study of internal control to establish a common definition of internal control 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 and improve their control systems. The COSO framework divides internal control into three broad objectives: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. Our rules relate only to reliability of financial reporting. Each of the objectives in the COSO framework is further broken down into five interrelated components: control environment, risk assessment, control activities, information and communication, and monitoring.

<sup>16</sup> In that release, we also cited the *Guidance on Assessing Control* published by the Canadian Institute of Chartered Accountants ("CoCo") and the report published by the Institute of Chartered Accountants in England & Wales *Internal Control: Guidance for Directors on the Combined Code* (known as the Turnbull Report) as examples of other suitable frameworks that issuers could choose in evaluating the effectiveness of their internal control over financial reporting. We encourage companies to examine and select a framework that may be useful in their own circumstances; we also encourage the further development of alternative frameworks.

<sup>17</sup> 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. The guidance includes evaluation tools; however, these tools are intended only to be illustrative.

this release is not intended to replace or modify the COSO framework or any other suitable framework.

In determining the need for additional guidance to management on how to conduct its evaluation, it is important to consider the steps that have been taken by the Commission and others to provide guidance to companies and audit firms. The Commission held its first roundtable discussion about implementation of the internal control reporting provisions on April 13, 2005. The 2005 roundtable sought input to consider the impact of the implementation of the Section 404 reporting requirements in view of the fact that Section 404 resulted in a major change for management and auditors. A broad range of interested parties, including representatives of managements and boards of domestic and foreign public companies, auditors, investors, legal counsel, and board members of the Public Company Accounting Oversight Board ("PCAOB"), participated in the discussion. We also invited and received written submissions from the public regarding Section 404 in advance of the roundtable.

Feedback obtained from the 2005 roundtable indicated that the internal control reporting requirements had led to an increased focus by management on ICFR. However, the feedback also identified particular areas which were in need of further clarification to reduce unnecessary costs and burdens while at the same time not jeopardizing the benefits of Section 404. In addition, feedback indicated that a number of the implementation issues arose from an overly conservative application of the Commission rules and PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements* ("AS No. 2"), and the requirements of AS No. 2 itself, as well as questions regarding the appropriate role of the auditor in management's evaluation process.

In response to this feedback, the Commission and its staff issued guidance on May 16, 2005,<sup>18</sup>

<sup>18</sup> *Commission Statement on Implementation of Internal Control Reporting Requirements*, Press Release No. 2005-74 (May 16, 2005); Division of Corporation Finance and Office of the Chief Accountant: *Staff Statement on Management's Report on Internal Control Over Financial Reporting* (May 16, 2005) (hereinafter "May 2005 Staff Guidance") available at <http://www.sec.gov/spotlight/soxcom/.htm>.

Also on May 16, 2005, the PCAOB and its staff issued guidance to auditors on their audits under AS No. 2. The PCAOB's guidance focused on areas in which the efficiency of the audit could be substantially improved. Topics included the

emphasizing that management, not the auditor, is responsible for determining the appropriate nature and form of internal controls for the company as well as their evaluation methods and procedures. The May 2005 Staff Guidance emphasized and clarified existing provisions of the rules and other Commission guidance relating to the exercise of professional judgment, the concept of reasonable assurance, and the permitted communications between management and auditors. Feedback has indicated that the May 2005 Staff Guidance was appropriate, and while we have incorporated certain sections of that guidance into the proposed interpretive guidance set forth in this release, the May 2005 Staff Guidance remains relevant.<sup>19</sup>

In its Final Report to the Commission, issued on April 23, 2006, the Commission's Advisory Committee on Smaller Public Companies ("Advisory Committee") raised a number of concerns regarding the ability of smaller companies to comply cost-effectively with the requirements of Section 404. The Advisory Committee identified as an overarching concern the difference in how smaller and larger public companies operate. The Advisory Committee 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.<sup>20</sup>

The Advisory Committee suggested that these characteristics create unique differences in how smaller companies

importance of the integrated audit, the role of risk assessment throughout the process, the importance of taking a top-down approach, and auditors' use of the work of others.

<sup>19</sup> The incorporation of our May 16, 2005 guidance into this guidance was generally supported in comments received in response to the *Concept Release Concerning Management's Reports on Internal Control Over Financial Reporting*, Release No. 34-54122 (July 11, 2006) [71 FR 40866] available at <http://www.sec.gov/rules/concept/2006/34-54122.pdf> (hereinafter "Concept Release"). See, for example, letters received from the American Electronics Association, Computer Sciences Corporation, American Institute of Certified Public Accountants, Institute of Management Accountants and Schering AG (available at <http://www.sec.gov/comments/s7-11-06/s71106.shtml>).

<sup>20</sup> *Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission* (April 23, 2006) at 35-36, available at <http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf> (hereinafter "Advisory Committee Final Report").

achieve effective ICFR that may not be adequately accommodated in AS No. 2 or other implementation guidance as currently applied in practice.<sup>21</sup> 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. Indeed, the Advisory Committee noted that costs in relation to revenue have been disproportionately borne by smaller public companies.<sup>22</sup>

The Advisory Committee Final Report sets forth several recommendations for the Commission to consider regarding the application of the Section 404 requirements to smaller public companies. The Advisory Committee recommended partial or complete exemptions from the internal control reporting requirements for specified types of smaller public companies under certain conditions, unless and until a framework is developed for assessing ICFR that recognizes the characteristics and needs of those companies. The Advisory Committee also recommended, among other things, that the Commission, COSO and the PCAOB provide additional guidance to management to help facilitate the design and evaluation of ICFR and make processes related to internal control more cost-effective.<sup>23</sup> In addition, some commenters on the Advisory Committee's exposure draft of its report suggested that the Commission reexamine the appropriate role of outside auditors in connection with the management assessment required by the rules implementing Section 404.<sup>24</sup>

Further, in April 2006, the U.S. Government Accountability Office issued a Report to the Committee on Small Business and Entrepreneurship, U.S. Senate, entitled *Sarbanes-Oxley Act, Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies*, which recommended that in considering the concerns of the Advisory Committee, the Commission should assess the available guidance for management to determine whether it is sufficient or whether additional action is needed. That report stated that management's implementation and evaluation efforts were largely driven by AS No. 2 because guidance was not available for

<sup>21</sup> *Id.* at 37.

<sup>22</sup> *Id.* at 33.

<sup>23</sup> *Id.* at 52.

<sup>24</sup> See, e.g., letter from BDO Seidman, LLP (April 3, 2006), available at <http://www.sec.gov/rules/other/265-23/bdoeidman9239.pdf>.

management.<sup>25</sup> Further, the GAO Report recommended that the Commission coordinate with the PCAOB to help ensure that the Section 404-related audit standards and guidance are consistent with any additional management guidance issued.<sup>26</sup>

On May 10, 2006, the Commission and PCAOB conducted a second Roundtable on Internal Control Reporting and Auditing Provisions to solicit feedback on accelerated filers' second year of compliance with the Section 404 requirements. Several participants indicated that their evaluation processes had improved from year one, but that additional improvements were needed. Although some expressed concern about being required to change the evaluation processes they have already implemented, a number of the participants expressed, at the roundtable and in their written comments, the view that additional management guidance was needed.<sup>27</sup>

On July 11, 2006, COSO published additional application guidance for its control framework, *Internal Control over Financial Reporting—Guidance for Smaller Public Companies*. This guidance is intended to assist the management of smaller companies in understanding and applying the COSO framework. It outlines principles fundamental to the five components of internal control described in the COSO framework. Further, this guidance defines each of these principles and describes the attributes of each. It also lists a variety of approaches that smaller companies can use to apply the principles and includes examples of how smaller companies have applied the principles. The Commission anticipates that the guidance will help organizations of all sizes that use the COSO framework to better understand and apply it to ICFR.

<sup>25</sup> United States Government Accountability Office Report to the Committee on Small Business and Entrepreneurship, U.S. Senate: *Sarbanes-Oxley Act: Consideration of Key Principles Needed in Addressing Implementation for Smaller Public Companies* (April 2006) at 52–53, available at <http://www.gao.gov/new.items/d06361.pdf> (hereinafter "GAO Report").

<sup>26</sup> *Id.* at 58.

<sup>27</sup> See transcript of Roundtable Discussion on Second Year Experiences with Internal Control Reporting and Auditing Provisions, May 10, 2006, Panels 1, 2, 3, and 5; letter from The Institute of Internal Auditors (IIA) (May 1, 2006); letter from Institute of Management Accountants (IMA) (May 4, 2006); letter from Canadian Bankers Association (CBA) (April 28, 2006); letter from Deloitte & Touche LLP (May 1, 2006); letter from Ernst & Young LLP (May 1, 2006); letter from KPMG LLP (May 1, 2006); letter from PricewaterhouseCoopers LLP (May 1, 2006) and letter from Pfizer Inc. (May 1, 2006), all available at <http://www.sec.gov/news/press/4-511.shtml>.

On July 11, 2006, the Commission issued a Concept Release to seek public feedback on the Commission's planned issuance of guidance regarding management's evaluation and assessment of the effectiveness of ICFR.<sup>28</sup> The Concept Release sought specific feedback in three areas described below, as well as inquired about whether there were other areas where guidance should also be provided.

- Risk and control identification (such as how management considers entity-level controls, financial statement account and disclosure level considerations, as well as fraud risks);<sup>29</sup>
- The methods or approaches available to management to gather evidence to support its assessment, and factors management should consider in determining the nature, timing and extent of its evaluation procedures; and
- Documentation requirements, including overall objectives of the documentation and factors that might influence documentation requirements.

The Commission received 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.<sup>30</sup> The Commission considered the feedback received in those comment letters in drafting this proposed interpretive guidance.

Further, the Commission has also received feedback that its guidance and ICFR rules have been interpreted as applying to non-profit and non-public organizations. The Commission does not regulate such organizations, and none of the Commission's guidance or rules is intended to apply to such organizations.

<sup>28</sup> See footnote 19 above for reference.

<sup>29</sup> The term "entity-level controls" as used in this document describes aspects of a system of internal control that have a pervasive effect on the entity's system of internal control such as controls related to the control environment (e.g., management's philosophy and operating style, integrity and ethical values, board or audit committee oversight; and assignment of authority and responsibility); controls over management override; the company's risk assessment process; centralized processing and controls, including shared service environments; controls to monitor results of operations; controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs; controls over the period-end financial reporting process; and policies that address significant business control and risk management practices. The term "company-level" is also commonly used to describe these controls.

<sup>30</sup> The public comments we received are available for inspection in the Commission's Public Reference Room at 100 F Street, NE., Washington DC 20549 in File No. S7-11-06. They are also available on-line at <http://www.sec.gov/comments/s7-11-06/s71106.shtml>.

## II. Introduction

To implement Section 404(a) of the Sarbanes-Oxley Act, the Commission adopted rules requiring that management annually issue a report that contains an assessment of the effectiveness of ICFR.<sup>31</sup> An overall objective of ICFR is to foster the preparation of reliable financial statements. Reliable financial statements must be materially accurate. Therefore, the central purpose of the evaluation is to assess whether there is a reasonable possibility of a material misstatement in the financial statements not being prevented or detected on a timely basis by the company's ICFR.<sup>32</sup>

Management's assessment is based on whether any material weaknesses exist as of the end of the fiscal year. A material weakness is 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.<sup>33</sup>

<sup>31</sup> Exchange Act Rules 13a-15(f) and 15d-15(f) [17 CFR 240.13a-15(f) and 15d-15(b)] define 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 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.

<sup>32</sup> There is a reasonable possibility of an event when the likelihood of the event is either "reasonably possible" or "probable" as those terms are used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*.

<sup>33</sup> Existing PCAOB auditing literature describes a material weakness as a control deficiency, or combination of control deficiencies, that result in more than a remote likelihood that a material misstatement of the company's annual or interim financial statements will not be prevented or detected. Our use of the phrase "reasonable possibility" rather than "more than remote" to describe the likelihood of a material error is intended to more clearly communicate the likelihood element. We note that the PCAOB has indicated that it intends to revise its definitions to use the phrase "reasonable possibility." AS No. 2

Management should implement and conduct an evaluation that is sufficient to provide it with a reasonable basis for its annual assessment. Management should use its own experience and informed judgment in designing an evaluation process that aligns with the operations, financial reporting risks and processes of the company.<sup>34</sup> If the evaluation process identifies material weaknesses that exist as of the end of the fiscal year, such weaknesses must be disclosed in management's annual report with a statement that ICFR is ineffective.<sup>35</sup> If the evaluation identifies no internal control deficiencies that constitute a material weakness, management assesses ICFR as effective.<sup>36</sup>

Management is required to assess as of the end of the fiscal year whether the company's ICFR is effective in providing reasonable assurance regarding the reliability of financial reporting.<sup>37</sup> Management is not required by Section 404 of Sarbanes-Oxley to assess other internal controls, such as controls solely implemented to meet a company's operational objectives. Further, "reasonable assurance" does not mean absolute assurance. ICFR cannot prevent or detect all misstatements, whether unintentional errors or fraud. Rather, the "reasonable assurance" referred to in the Commission's implementing rules relates to similar language in the FCPA. Exchange Act Section 13(b)(7) defines

establishes that a control is deficient when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. The definition formulated here is intended to be consistent with its use in existing auditing literature and practice.

<sup>34</sup> This point also is made in one of the publicly available and commonly used assessment tools—the third volume of the report by 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."

<sup>35</sup> This focus on material weaknesses will lead to a better understanding by investors of internal control over financial reporting, as well as its inherent limitations. Further, the Commission's rules implementing Section 404, by providing for public disclosure of material weaknesses, concentrate attention on the most important internal control issues.

<sup>36</sup> If management's evaluation process identifies material weaknesses, but all material weaknesses are remediated by the end of the fiscal year, management may exclude disclosure of those from its assessment and state that ICFR is effective as of the end of the fiscal year. However, management should consider whether disclosure of the remediated material weaknesses is appropriate or required under Item 307 or Item 308 of Regulations S-K or S-B or other Commission disclosure rules.

<sup>37</sup> See Exchange Act Rules 13a-15 and 15d-15.

"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."<sup>38</sup> The Commission has long held that "reasonableness" is not an "absolute standard of exactitude for corporate records."<sup>39</sup> In addition, the Commission 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 appropriate potential conduct, conclusions or methodologies upon which an issuer may reasonably base its decisions.

This release proposes guidance regarding matters we believe will help management design and conduct its evaluation and assess the effectiveness of ICFR. The guidance assumes management has established and maintains a system of internal accounting controls as required by the FCPA. Further, it does not explain how management should design its ICFR to comply with the control framework it has chosen. To allow appropriate flexibility, the guidance does not provide a checklist of steps management should perform in completing its evaluation. Rather, it describes a top-down, risk-based approach that allows for the exercise of significant judgment so that management can design and conduct an evaluation that is tailored to its company's individual circumstances.<sup>40 41</sup>

The proposed guidance is organized around two broad principles. The first principle is that management should evaluate the design of the controls that

<sup>38</sup> 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).

<sup>39</sup> Release No. 34-17500 (January 29, 1981) [46 FR 11544].

<sup>40</sup> Because management is responsible for maintaining effective internal control over financial reporting, this proposed interpretive guidance does not specifically address the role of the board of directors or audit committee in a company's evaluation and assessment of ICFR. However, we would ordinarily expect a board of directors or audit committee, as part of its oversight responsibilities for the company's financial reporting, to be knowledgeable and informed about the evaluation process and management's assessment, as necessary in the circumstances.

<sup>41</sup> See footnote 42 below.

it has implemented to determine whether they adequately address the risk that a material misstatement in the financial statements would not be prevented or detected in a timely manner. The guidance describes a top-down, risk-based approach to this principle, including the role of entity-level controls in assessing financial reporting risks and the adequacy of controls. The proposed guidance promotes efficiency by allowing management to focus on those controls that are needed to adequately address the risk of a material misstatement in its financial statements. There is no requirement in our guidance to identify every control in a process or document the business processes impacting ICFR. Rather, under the approach described herein, management focuses its evaluation process and the documentation supporting the assessment on those controls that it believes adequately address the risk of a material misstatement in the financial statements. For example, if management determines that the risks for a particular financial reporting element are adequately addressed by an entity-level control, no further evaluation of other controls is required.

The second principle is that management's evaluation of evidence about the operation of its controls should be based on its assessment of risk. The proposed guidance provides an approach for making risk-based judgments about the evidence needed for the evaluation. This allows management to align the nature and extent of its evaluation procedures with those areas of financial reporting that pose the greatest risks to reliable financial reporting (*i.e.*, whether the financial statements are materially accurate). As a result, management may be able to use more efficient approaches to gathering evidence, such as self-assessments, in low-risk areas and perform more extensive testing in high-risk areas.

By following these two principles, we believe companies of all sizes and complexities will be able to implement our rules effectively and efficiently.<sup>42</sup> As smaller public companies generally have less complex internal control systems than larger public companies, this top-down, risk-based approach should enable smaller public companies in particular to scale and tailor their

<sup>42</sup> Commenters on the Concept Release were supportive of principles-based guidance that applies to all companies. See for example, letters regarding file number S7-11-06 of: Financial Executives International, Metlife, and Siemens AG at <http://www.sec.gov/comments/s7-11-06/s71106.shtml>.

evaluation methods and procedures to fit their own facts and circumstances.<sup>43</sup> We encourage smaller public companies to take advantage of the flexibility and scalability of this approach to conduct an efficient evaluation of internal control over financial reporting.<sup>44</sup> Further, we believe the proposed guidance will assist companies of all sizes in completing the annual evaluation of ICFR in an effective and efficient manner by addressing a number of the common areas of concern that have been identified over the past two years. For example, the proposed guidance:

- Explains how to vary approaches for gathering evidence to support the evaluation based on risk assessments;
- Explains the use of “daily interaction,” self-assessment, and other on-going monitoring activities as evidence in the evaluation;
- Explains the purpose of documentation and how management has flexibility in approaches to documenting support for its assessment;
- Provides management significant flexibility in making judgments regarding what constitutes adequate evidence in low-risk areas; and
- Allows for management and the auditor to have different testing approaches.

The information management gathers and analyzes from its evaluation process serves as the basis for its assessment on the effectiveness of its ICFR. The extent of effort required for a reasonable evaluation process will largely depend on the company’s existing policies, procedures and practices. For example, in some situations management may determine that its existing activities, which may be undertaken for other reasons, provide information that is relevant to the assessment. In other situations, management may have to implement additional procedures to gather and analyze the information needed to provide a reasonable basis for its annual assessment.

<sup>43</sup> See Advisory Committee Final Report at 35–38.

<sup>44</sup> While a company’s individual facts and circumstances should be considered in determining whether a company is a smaller public company, a company’s market capitalization and annual revenues are useful indicators of its size and complexity. In light of the Advisory Committee Final Report and the SEC’s rules defining “accelerated filers” and “large accelerated filers,” companies with a market capitalization of approximately \$700 million or less, with reported annual revenues of approximately \$250 million or less, should be presumed to be “smaller companies,” with the smallest of these companies, with a market capitalization of approximately \$75 million or less, described as “microcaps.”

### III. Proposed Interpretive Guidance

The proposed interpretive guidance addresses the following topics:

- A. The Evaluation Process
  1. Identifying Financial Reporting Risks and Controls
    - a. Identifying Financial Reporting Risks
    - b. Identifying Controls that Adequately Address Financial Reporting Risks
    - c. Consideration of Entity-level Controls
    - d. Role of General Information Technology Controls
    - e. Evidential Matter to Support the Assessment
  2. Evaluating Evidence of the Operating Effectiveness of ICFR
    - a. Determining the Evidence Needed to Support the Assessment
    - b. Implementing Procedures to Evaluate Evidence of the Operation of ICFR
    - c. Evidential Matter to Support the Assessment
  3. Multiple Location Considerations
- B. Reporting Considerations
  1. Evaluation of Control Deficiencies
  2. Expression of Assessment of Effectiveness of ICFR by Management and the Registered Public Accounting Firm
  3. Disclosures About Material Weaknesses
  4. Impact of a Restatement of Previously Issued Financial Statements on Management’s Report on ICFR
  5. Inability to Assess Certain Aspects of ICFR

#### A. The Evaluation Process

The objective of the evaluation of ICFR is to provide management with a reasonable basis for its annual assessment as to whether any material weaknesses in ICFR exist as of the end of the fiscal year. To meet this objective, management identifies the risks to reliable financial reporting, evaluates whether the design of the controls which address those risks is such that there is a reasonable possibility that a material misstatement in the financial statements would not be prevented or detected in a timely manner, and evaluates evidence about the operation of the controls included in the evaluation based on its assessment of risk. The evaluation process will vary from company to company; however, the approach we discuss is a top-down, risk-based approach which we believe is typically most efficient and effective.

The evaluation process guidance is presented in two sections. The first section explains an approach to

identifying financial reporting risks and evaluating whether the controls management has implemented are designed to address those risks. The second section describes an approach for making judgments about the methods and procedures for evaluating whether the operation of ICFR is effective. Both sections explain how entity-level controls<sup>45</sup> impact the evaluation process as well as how management focuses its evaluation efforts on the greatest risks.

Under the Commission’s rules, management’s annual assessment must be made in accordance with a suitable control framework’s definition of effective internal control.<sup>46</sup> These control frameworks define elements of internal control that are expected to be present and functioning in an effective internal control system. In assessing effectiveness, management evaluates whether its ICFR includes policies, procedures and activities that address all of the elements of internal control that the applicable control framework describes as necessary for an internal control system to be effective. The framework elements describe the characteristics of an internal control system that may be relevant to individual areas of the company’s ICFR, pervasive to many areas, or entity-wide. Therefore, management’s evaluation process includes not only controls involving particular areas of financial reporting, but also the entity-wide and other pervasive elements of internal control that are defined by the control frameworks. This guidance is not intended to replace the elements of an effective system of internal control as defined within a control framework.

#### 1. Identifying Financial Reporting Risks and Controls

The approach described herein allows management to identify controls and maintain supporting evidential matter for its controls in a manner that is tailored to a company’s financial reporting risks (as defined below). Thus, management can avoid identifying and

<sup>45</sup> See footnote 29 above.

<sup>46</sup> For example, both the COSO framework and the Turnbull Report state that determining whether a system of internal control is effective is a subjective judgment resulting from an assessment of whether the five components (*i.e.*, control environment, risk assessment, control activities, monitoring, and information and communication) are present and functioning effectively. Although CoCo states that an assessment of effectiveness be made against twenty specific criteria, it acknowledges that the criteria can be regrouped into different structures, and includes a table showing how the criteria can be regrouped into the five-component structure of COSO. Thus, these five components are also criteria for effective internal control.

documenting controls that are not important to achieving the objectives of ICFR. Management should assess whether its controls are 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 (“GAAP”).<sup>47</sup> The evaluation begins with the identification and assessment of the risks to reliable financial reporting (*i.e.*, materially accurate financial statements), including changes in those risks. Management then evaluates whether it has controls placed in operation that are designed to adequately address those risks. Management ordinarily would consider the company’s entity-level controls in both its assessment of risk and in identifying which controls adequately address the risk. The controls that management identifies as adequately addressing the financial reporting risks are then subject to procedures to evaluate evidence of the operating effectiveness, as determined pursuant to Section III.A.2.

The effort necessary to conduct an initial evaluation of financial reporting risks (as defined below) and the related controls will vary among companies, partly because this effort will depend on management’s existing financial reporting risk assessment and monitoring activities.<sup>48</sup> Even so, in subsequent years for most companies, management’s effort should ordinarily be significantly less because subsequent evaluations should be more focused on changes in risks and controls rather than identification of all financial reporting risks and the related controls. Further, in each subsequent year, the evidence necessary to reasonably support the assessment will only need to be updated from the prior year(s), not recreated anew.

<sup>47</sup> Management of foreign private issuers that file financial statements prepared in accordance with home country generally accepted accounting principles or International Financial Reporting Standards with a reconciliation to U.S. GAAP should plan and conduct their evaluation process based on their primary financial statements (*i.e.*, home country GAAP or IFRS) rather than the reconciliation to U.S. GAAP.

<sup>48</sup> Monitoring activities are those that assess the quality of internal control performance over time. These activities involve assessing the design and operation of controls on a timely basis and taking necessary corrective actions. This process is accomplished through on-going monitoring activities, separate evaluations by internal audit or personnel performing similar functions, or a combination of the two. On-going monitoring activities are often built into the normal recurring activities of an entity and include regular management and supervisory review activities.

#### a. Identifying Financial Reporting Risks

Ordinarily, the identification of financial reporting risks begins with evaluating how the requirements of GAAP apply to the company’s business, operations and transactions. Management must provide investors with financial statements that fairly present the company’s financial position, results of operations and cash flows in accordance with GAAP. A lack of fair presentation involves material misstatements (including omissions) in one or more of the financial statement amounts or disclosures (“financial reporting elements”).

Management uses its knowledge and understanding of the business, its organization, operations, and processes to consider the sources and potential likelihood of misstatements in financial reporting elements and identifies those that could result in a material misstatement to the financial statements (“financial reporting risks”). Internal and external risk factors that impact the business, including the nature and extent of any changes in those risks, may give rise to financial reporting risks. Financial reporting risks may also arise from sources such as the initiation, authorization, processing and recording of transactions and other adjustments that are reflected in financial reporting elements. Management’s evaluation of financial reporting risks should also consider the vulnerability of the entity to fraudulent activity (*e.g.*, fraudulent financial reporting, misappropriation of assets and corruption) and whether any of those exposures could result in a material misstatement of the financial statements.<sup>49</sup>

The methods and procedures for identifying financial reporting risks will vary based on the characteristics of the company.<sup>50</sup> These characteristics include, among others, the size, complexity, and organizational structure of the company and its processes and financial reporting environment, as well

<sup>49</sup> See “Management Antifraud Programs and Controls—Guidance to Help Prevent, Deter, and Detect Fraud,” which was issued jointly by seven professional organizations and is included as an exhibit to AU Sec. 316, *Consideration of Fraud in a Financial Statement Audit* (as adopted on an interim basis by the PCAOB in PCAOB Rule 3200T).

<sup>50</sup> To provide management the flexibility needed to implement an evaluation process that best suits its particular circumstances; the guidance in this proposed interpretative release does not prescribe a particular methodology for the identification of risks and controls. While the May 2005 Staff Guidance used the term “significant account,” which is used in AS No. 2, we are not requiring that companies use the guidance in the auditing literature to conduct their evaluation approach. The Commission encourages the development of methodologies and tools that meet the objectives of the ICFR evaluation.

as the control framework used by management. For example, to effectively identify financial reporting risks in larger businesses or in situations involving complex business processes, management’s evaluation may need to involve employees with specialized knowledge who collectively have the necessary understanding of the requirements of GAAP, the underlying business transactions, the process activities, including the role of computer technology, that are required to initiate, authorize, record and process transactions, and the points within the process at which a material misstatement, including a misstatement due to fraud, may occur. In contrast, in a small company with less complex business processes that operate on a centralized basis and with little change in the risks or processes, management’s daily involvement with the business may provide it with adequate knowledge to appropriately identify financial reporting risks.

#### b. Identifying Controls That Adequately Address Financial Reporting Risks

Management should evaluate whether it has controls placed in operation (*i.e.*, in use) that are designed to address the company’s financial reporting risks.<sup>51</sup> The determination of whether an individual control, or a combination of controls, adequately addresses a financial reporting risk involves judgments about both the likelihood and potential magnitude of misstatements arising from the financial reporting risk. For purposes of the evaluation of ICFR, the controls are not adequate when their design is such that there is a reasonable possibility that a misstatement in the related financial reporting element that could result in a material misstatement of the financial statements will not be prevented or detected on a timely basis.<sup>52</sup> If management determines that

<sup>51</sup> A control consists of a specific set of policies, procedures, and activities designed to meet an objective. A control may exist within a designated function or activity in a process. A control’s impact on ICFR may be entity-wide or specific to a class of transactions or application. Controls have unique characteristics—they can be: automated or manual; reconciliations; segregation of duties; review and approval authorizations; safeguarding and accountability of assets, preventing error or fraud detection, or disclosure. Controls within a process may consist of financial reporting controls and operational controls (*i.e.*, those designed to achieve operational objectives).

<sup>52</sup> The use of the phrase “reasonable possibility that a misstatement in the related financial reporting element that could result in a material misstatement of the financial statements” is intended solely to assist management in identifying matters for disclosure under Item 308 of Regulation S-K. It is not intended to interpret or describe management’s responsibility under FCPA or modify

its controls are not adequately designed, a deficiency exists that must be evaluated to determine whether it is a material weakness. The guidance in Section III.B.1. is designed to assist management with that evaluation.<sup>53</sup>

Management may identify controls for a financial reporting element that are preventive, detective or a combination of both.<sup>54</sup> It is not necessary to identify all controls that exist. Rather, the objective of this evaluation step is to identify controls that adequately address the risk of misstatement for the financial reporting element that could result in a material misstatement in the financial statements. To illustrate, management may determine for a financial reporting element that a control within the company's period-end financial reporting process (*i.e.*, an entity-level control) is designed in a manner that adequately addresses the risk that a misstatement in interest expense, that could result in a material misstatement in the financial statements, may occur and not be detected. In such a case, management may not need to identify any additional controls related to interest expense.

Management may consider the efficiency with which evidence of the operation of a control can be evaluated when identifying the controls that adequately address the financial reporting risks. For example, when more than one control exists that individually addresses a particular risk (*i.e.*, redundant controls), management may decide to select the control for which evidence of operating effectiveness can be obtained more efficiently. Moreover, when adequate general information technology ("IT") controls exist, and management has determined the operation of such controls is effective, management may determine that automated controls may be more efficient to evaluate than manual controls. Considering the efficiency

a control framework's definition of what constitutes an effective system of internal control.

<sup>53</sup> A deficiency in the design of ICFR exists when (a) necessary controls are missing or (b) existing controls are not properly designed so that, even if the control operates as designed, the financial reporting risks would not be addressed. AS No. 2 states that a deficiency in the design of ICFR exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective is not always met. See AS No. 2 ¶ 8.

<sup>54</sup> Preventive controls have the objective of preventing the occurrence of errors or fraud that could result in a misstatement of the financial statements. Detective controls have the objective of detecting errors or fraud that has already occurred that could result in a misstatement of the financial statements. Preventive and detective controls may be completely manual, involve some degree of computer automation, or be completely automated.

with which the operation of a control can be evaluated will often enhance the overall efficiency of the evaluation process.

When identifying the controls that address financial reporting risks, management may learn information about the characteristics of the controls, such as the judgment required to operate them or their complexity, that are considered in its judgments about the risk that the control will fail to operate as designed. Section III.A.2. discusses how these characteristics are considered in determining the nature and extent of evidence of the operation of the control that management evaluates.

At the end of this identification process, management will have identified for testing only those controls that are needed to adequately address the risk of a material misstatement in its financial statements and for which evidence about their operation can be obtained most efficiently.

#### c. Consideration of Entity-level Controls

Management considers entity-level controls when identifying and assessing financial reporting risks and related controls for a financial reporting element. In doing so, it is important for management to consider the nature of the entity-level controls and how they relate to the financial reporting element.<sup>55</sup> Some entity-level controls are designed to operate at the process, transaction or application level and might adequately prevent or detect on a timely basis misstatements in one or more financial reporting elements that could result in a material misstatement to the financial statements. On the other hand, an entity-level control may be designed to identify possible breakdowns in lower-level controls, but not in a manner that would, by itself, sufficiently address the risk that misstatements to financial reporting elements that could result in a material misstatement to the financial statements will be prevented or detected on a timely basis.

The more indirect the relationship to a financial reporting element, the less effective a control may be in preventing or detecting a misstatement. Some entity-level controls, such as the control environment (*e.g.*, tone at the top and entity-wide programs such as codes of

<sup>55</sup> Controls can be either directly or indirectly related to a financial reporting element. Controls that are designed to have a specific effect on a financial reporting element are considered directly related. For example, controls established to ensure that personnel are properly counting and recording the annual physical inventory relate directly to the existence of the inventory.

conduct and fraud prevention), are indirectly related to a financial reporting element and may not, by themselves, be effective at preventing or detecting a misstatement in a financial reporting element. Therefore, while management ordinarily would consider entity-level controls of this nature when assessing financial reporting risks and evaluating the adequacy of controls, it is unlikely management will identify only this type of entity-level control as adequately addressing a financial reporting risk identified for a financial reporting element.<sup>56</sup>

#### d. Role of General Information Technology Controls

Controls that management identifies as addressing financial reporting risks may be automated (*e.g.*, application controls that update accounts in the general ledger for subledger activity) or dependent upon IT functionality (*e.g.*, a control that manually investigates items contained in a computer generated exception report). In these situations, management's evaluation process generally considers the design and operation of the automated or IT dependent controls management identifies and the relevant general IT controls over the applications providing the IT functionality. While general IT controls ordinarily do not directly prevent or detect material misstatements in the financial statements, the proper and consistent operation of automated or IT dependent controls depends upon effective general IT controls.

Aspects of general IT controls that may be relevant to the evaluation of ICFR will vary depending upon a company's facts and circumstances. Ordinarily, management should consider whether, and the extent to which, general IT control objectives related to program development, program changes, computer operations, and access to programs and data apply to its facts and circumstances. For purposes of the evaluation of ICFR, management only needs to evaluate those general IT controls that are necessary to adequately address financial reporting risks.

<sup>56</sup> Many commenters on the Concept Release requested clarification of the role of entity-level controls in management's evaluation. See for example, letters regarding file number S7-11-06 of Aerospace Industries Association, Sprint Nextel Corporation, Unum Provident, Dupont, Deutsche Telekom, Ernst & Young LLP, Deloitte & Touche LLP, and Grant Thornton LLP at <http://www.sec.gov/comments/s7-11-06/s71106.shtml>. See Section III.A.2.a. for additional guidance on entity-level controls.

e. **Evidential Matter To Support the Assessment**

As part of its evaluation of ICFR, management must maintain reasonable support for its assessment.<sup>57</sup> Documentation of the design of the controls management has placed in operation to adequately address the financial reporting risks is an integral part of the reasonable support. The form and extent of the documentation will vary depending on the size, nature, and complexity of the company. It can take many forms (*e.g.*, paper documents, electronic, or other media) and it can be presented in a number of ways (*e.g.*, policy manuals, process models, flowcharts, job descriptions, documents, internal memorandums, forms, etc). The documentation does not need to include all controls that exist within a process that impacts financial reporting. Rather, and more importantly, the documentation can be focused on those controls that management concludes are adequate to address the financial reporting risks.<sup>58</sup>

In addition to providing support for the assessment of ICFR, documentation of the design of controls also supports other objectives of an effective system of internal control. For example, it serves as evidence that controls within ICFR, including changes to those controls, have been identified, are capable of

<sup>57</sup> See instructions to Item 308 of Regulations S-K and S-B.

<sup>58</sup> Commenters on the Concept Release were supportive of guidance regarding the form, nature, and extent of documentation. See for example letters regarding file number S7-11-06 of EDS, Controllers' Leadership Roundtable, Sasol Group, New York State Society of Certified Public Accountants, Grant Thornton LLP, and Financial Executives International at <http://www.sec.gov/comments/s7-11-06/s71106.shtml>. Section III.A.2.c also provides guidance with regard to the documentation required to support management's evaluation of operating effectiveness.

being communicated to those responsible for their performance, and are capable of being monitored by the company. The documentation also provides the foundation for appropriate communication concerning responsibilities for performing controls and for the company's evaluation and monitoring of the operation of controls.

Management should also consider the need to maintain evidential matter, including documentation, of the entity-wide and other pervasive elements of its ICFR that it believes address the elements of internal control that its chosen control framework prescribes as necessary for an effective system of internal control.<sup>59</sup>

2. **Evaluating Evidence of the Operating Effectiveness of ICFR**

Management should evaluate evidence of the effective operation of ICFR. A control operates effectively when it is performed in a manner consistent with its design by individuals with the necessary authority and competency. Management ordinarily focuses its evaluation of the operation of controls on those areas of ICFR that pose the highest risk to reliable financial reporting. The evaluation procedures that management uses to gather evidence about the effective operation of ICFR should be tailored to its assessment of the risk characteristics of both the individual financial reporting elements and the related controls (collectively, ICFR risk). Management's assessment of ICFR risk also considers the impact of entity-level controls, such as the relative strengths and weaknesses of the control environment, which may influence management's judgments about the risks of failure for particular controls. Management varies the nature,

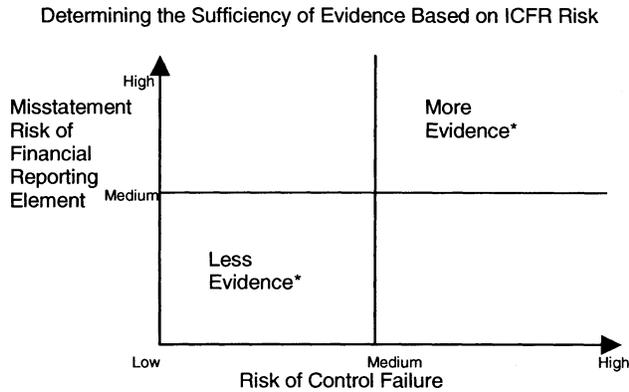
<sup>59</sup> *Id.*

timing and extent of the evaluation methods it implements in response to its judgments about ICFR risk.

Evidence about the effective operation of controls may be obtained from direct-testing of controls and on-going monitoring activities. The nature, timing and extent of evaluation procedures necessary for management to obtain sufficient evidence of the effective operation of a control depends on the assessed ICFR risk. In determining whether the evidence obtained is sufficient to provide a reasonable basis for its evaluation of the operation of ICFR, management should consider not only the quantity of evidence (*e.g.*, sample size) but also qualitative characteristics of the evidence. The qualitative characteristics of the evidence include the nature of the evaluation procedures performed, the period of time to which the evidence relates, the objectivity of those evaluating the controls, and, in the case of monitoring controls, the extent of validation through direct testing of underlying controls. For any individual control, different combinations of the nature, timing, and extent of evaluation procedures may provide sufficient evidence. The sufficiency of evidence is not determined by any of these attributes individually.

a. **Determining the Evidence Needed To Support the Assessment**

Management should evaluate the ICFR risk of the controls identified in Section III.A.1. to determine the evidence needed to support the assessment. The risk assessment should consider the impact of the characteristics of the financial reporting elements to which the controls relate and the characteristics of the controls themselves. This concept is demonstrated in the following diagram.



\* The references to “more” or “less” include both the quantitative and qualitative characteristics of the evidence (*i.e.*, its sufficiency).

Characteristics of the financial reporting element that management considers include both the materiality of the financial reporting element and the susceptibility of the underlying account balances, transactions or other supporting information to material misstatement. As the materiality of the financial reporting element increases in relation to the amount of misstatement that would be considered material to the financial statements, management’s assessment of risk generally would correspondingly increase. In addition, financial reporting elements would generally have higher risk when they include transactions, account balances or other supporting information that is prone to misstatement. For example, elements which: (1) Involve judgment in determining the recorded amounts; (2) are susceptible to fraud; (3) have complexity in the underlying accounting requirements; or (4) are subject to environmental factors, such as technological and/or economic developments, would generally be assessed as higher risk.

Management also considers the likelihood that a control might fail to operate effectively. That likelihood may depend on, among other things, the type of control (*i.e.*, manual or automated), the complexity of the control, the risk of management override, the judgment required to operate the control, the nature and materiality of misstatements that the control is intended to prevent or detect, and the degree to which the control relies on the effectiveness of other controls (*e.g.*, general IT controls). For example, management’s risk assessment would be higher for a financial reporting element that involves controls whose operation requires significant judgment than for a financial reporting element that

involves non-complex controls requiring little judgment on behalf of management.

Certain financial reporting elements, such as those involving significant accounting estimates,<sup>60</sup> related party transactions, or critical accounting policies<sup>61</sup> generally would be assessed as having higher risk for both the risk of material misstatement to the financial reporting element and the risk of control failure. When the controls related to these financial reporting elements are subject to the risk of management override, involve significant judgment, or are complex, they should generally be assessed as having higher ICFR risk.

When a combination of controls is required to adequately address the risks of a financial reporting element, management should analyze the risk characteristics of each control. This is because the controls associated with a given financial reporting element may not necessarily share the same risk characteristics. For example, a financial reporting element involving significant estimation may require a combination of

automated controls that accumulate source data and manual controls that require highly judgmental determinations of assumptions. In this case, the automated controls may be subject to a system that is stable (*i.e.*, has not undergone significant change) and is supported by effective general controls and are therefore assessed as lower risk, whereas the manual controls would be assessed as higher risk.

The existence of entity-level controls (*e.g.*, controls within the control environment) may influence management’s determination of the evidence needed to sufficiently support its assessment. For example, management’s judgment about the likelihood that a control fails to operate effectively may be influenced by a highly effective control environment and thereby impact the evidence evaluated for that control. However, a strong control environment would not eliminate the need for evaluation procedures that consider the effective operation of the control in some manner.<sup>62</sup>

#### b. Implementing Procedures To Evaluate Evidence of the Operation of ICFR

The methods and procedures management uses to gather evidence about the effective operation of controls are based on its assessment of the ICFR risk. Therefore, the methods and procedures, including the timing of when they are performed, are a function of the evidence that management considers necessary to provide reasonable support for its assessment of ICFR based on the assessment of ICFR risk. These procedures may be integrated with the daily responsibilities

<sup>60</sup> “Significant accounting estimates” referred to here relate to accounting estimates or assumptions where the nature of the estimates or assumptions is material due to the levels of subjectivity and judgment necessary to account for highly uncertain matters or the susceptibility of such matters to change; and the impact of the estimates and assumptions on financial condition or operating performance is material. See *Interpretation: Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations*. Release No. 33-8350 (December 19, 2003).

<sup>61</sup> “Critical accounting policies” are defined as those policies that are most important to the financial statement presentation, and require management’s most difficult, subjective, or complex judgments, often as the result of a need to make estimates about the effect of matters that are inherently uncertain. See *Action: Cautionary Advice Regarding Disclosure About Critical Accounting Policies*. Release No. 33-8040 (December 12, 2001).

<sup>62</sup> See references at footnote 56 to comments received related to the role of entity-level controls within management’s evaluation.

of its employees or implemented specifically for purposes of the ICFR evaluation. Evidence that is relevant to the assessment may come from activities that are performed for other reasons (e.g., day-to-day activities to manage the operations of the business). Further, activities performed to meet the monitoring objectives of the control framework will provide evidence to support the assessment.<sup>63</sup>

The evidence management evaluates may come from a combination of on-going monitoring and direct testing of controls. On-going monitoring includes activities that provide information about the operation of controls and may be obtained, for example, through self-assessment<sup>64</sup> procedures and the analysis of performance measures designed to track the operation of controls.<sup>65</sup> Direct tests of controls are tests performed periodically to provide evidence as of a point in time and may provide information about the reliability of on-going monitoring activities.

The risk assessments discussed in Section III.A.2.a. can assist management in determining the evaluation procedures that provide reasonable support for the assessment. As the assessed risk increases, management will ordinarily adjust the nature of the evidence that is obtained. For example,

<sup>63</sup> Many commenters on the Concept Release requested guidance clarifying that evidence relevant to supporting the evaluation may come from activities that are integrated into management's daily activities or performed for other reasons. See, for example, letters regarding file number S7-11-06 of EDS, American Electric Power and the Hundred Group of Finance Directors at <http://www.sec.gov/comments/s7-11-06/s71106.shtml>.

<sup>64</sup> Self-assessment is a broad term that refers to different types of procedures performed by various parties. It includes an assessment made by the same personnel who are responsible for performing the control. However, self-assessment may also be used to refer to 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 carried out with varying degrees of objectivity. The sufficiency of the evidence derived from self-assessment depends on how it is implemented and the objectivity of those performing the assessment. COSO's 1992 framework defines self-assessments as "evaluations where persons responsible for a particular unit or function will determine the effectiveness of controls for their activities."

<sup>65</sup> Management's evaluation process may also consider the results of key performance indicators ("KPI's") in which management reconciles operating and financial information with its knowledge of the business. While these KPI's may indicate a potential misstatement in a financial reporting element and therefore are relevant to meeting the objectives of ICFR, they generally do not monitor the effective operation of other controls. The procedures that management implements pursuant to this section should evaluate the effective operation of these KPI type controls when they are identified pursuant to Section III.A.1.b. as addressing financial reporting risk.

management can vary the nature of evidence from on-going monitoring by adjusting the extent of validation through periodic direct testing of the underlying controls and/or adjusting the objectivity of those performing the self-assessments. Management can also vary the nature of evidence obtained by adjusting the period of time covered by direct testing. When ICFR risk is assessed as high, management's evaluation would ordinarily include evidence obtained from direct testing. Further, management's evaluation would ordinarily consider evidence from a reasonable period of time during the year, including the fiscal year-end. For lower risk areas, management may conclude that evidence from on-going monitoring is sufficient and that no direct testing is required.<sup>66</sup>

In smaller companies, management's daily interaction with its controls may provide it with sufficient knowledge about their operation to evaluate the operation of ICFR. Knowledge from daily interaction includes information obtained by those responsible for evaluating the effectiveness of ICFR through their on-going direct knowledge and direct supervision of control operation. Management should consider its particular facts and circumstances when determining whether or not its daily interaction with controls provides sufficient evidence for the evaluation. For example, daily interaction may provide sufficient evidence when the operation of controls is centralized and the number of personnel involved in their operation is limited. Conversely, daily interaction in companies with multiple management reporting layers or operating segments would generally not provide sufficient evidence because those responsible for assessing the effectiveness of ICFR would not ordinarily be sufficiently knowledgeable about the operation of the controls. In these situations, management would ordinarily utilize direct testing or on-going monitoring type evaluation procedures to have reasonable support for the assessment.<sup>67</sup>

<sup>66</sup> Commenters on the Concept Release were supportive of guidance on factors that should be considered in using a risk-based evaluation. See, for example, letters regarding file number S7-11-06 of Aerospace Industries Association, American Institute of Certified Public Accountants, American Electric Power, Edison Electric Institute, and PricewaterhouseCoopers LLP at <http://www.sec.gov/comments/s7-11-06/s71106.shtml>. Section III.A.2.a. also provides guidance on a risk-based evaluation.

<sup>67</sup> Commenters on the Concept Release were supportive of guidance on how management's daily interaction can support the evaluation. See, for example, letters regarding file number S7-11-06 of U.S. Oncology, Inc., EDS, American Electric Power, MetLife, Texas Society of Certified Public

Management evaluates the evidence it gathers to determine whether the operation of a control is effective. This evaluation considers whether the control operated as designed and includes matters such as how the control was applied, the consistency with which it was applied, and whether the person performing the control possesses the necessary authority and competence to perform the control effectively. If management determines that the operation of the control is not effective, a deficiency exists that must be evaluated to determine whether it is a material weakness.

#### c. Evidential Matter To Support the Assessment

Management's assessment must be supported by evidential matter that provides reasonable support for its assessment. The nature of the evidential matter may vary based on the assessed level of risk of the underlying controls and other circumstances, but we would expect reasonable support for an assessment to include the basis for management's assessment, including documentation of the methods and procedures it utilizes to gather and evaluate evidence. The evidential matter may take many forms and will vary depending on the assessed level of risk for controls over each of its financial reporting elements. For example, management may document its overall strategy in a comprehensive memorandum that establishes the evaluation approach, the evaluation procedures, and the basis for conclusions for each financial reporting element. Management may determine that it is not necessary to separately maintain copies of the evidence it evaluates; however, the evidential matter within the company's books and records should be sufficient to provide reasonable support for its assessment. For example, in smaller companies, where management's daily interaction with its controls provides the basis for its assessment, management may have limited documentation created specifically for the evaluation of ICFR. However, in these instances, management should consider whether reasonable support for its assessment would include documentation of how its interaction provided it with sufficient evidence. This documentation might include memoranda, e-mails, and

Accountants, and the Controllers' Leadership Roundtable at <http://www.sec.gov/comments/s7-11-06/s71106.shtml>.

instructions or directions from management to company employees.<sup>68</sup>

Further, management should also consider the degree of complexity of the control, the level of judgment required to operate the control, and the risk of misstatement in the financial reporting element that could result in a material misstatement in the financial statements in determining the nature of supporting evidential matter. As these factors increase, management may determine that evidential matter supporting the assessment should be separately maintained.<sup>69</sup> For example, management may decide that separately maintained documentation will assist the audit committee in exercising its oversight of the company's financial reporting.

If management believes that the operation of the entity-wide and other pervasive elements of its ICFR address the elements of internal control that its applicable framework describes as necessary for an effective system, then the evidential matter constituting reasonable support for management's assessment would ordinarily include documentation of how management formed that belief.<sup>70</sup>

### 3. Multiple Location Considerations<sup>71</sup>

Management's consideration of financial reporting risks generally includes all of its locations or business units.<sup>72</sup> Management may determine that financial reporting risks are adequately addressed by controls which operate centrally, in which case the evaluation approach is similar to that of a business with a single location or business unit. When the controls necessary to address financial reporting risks operate at more than one location or business unit, management would generally evaluate evidence of the operation of the controls at the individual locations or business units.

In situations where management determines that the ICFR risk of the controls (as determined through Section III.A.2.a) that operate at individual locations or business units is low, management may determine that evidence gathered through self-assessment routines or other on-going monitoring activities, when combined

with the evidence derived from a centralized control that monitors the results of operations at individual locations, may constitute sufficient evidence for the evaluation. In other situations, management may determine that, because of the complexity or judgment in the operation of the controls at the individual location, the risks of the controls are high, and therefore more evidence is needed about the effective operation of the controls at the location.

When performing its evaluation of the risk characteristics of the controls identified, management should consider whether there are location-specific risks that might impact the risk that a control might fail to operate effectively. Additionally, there may be pervasive factors at a given location that cause all controls, or a majority of controls, at that location to be considered higher risk. Management should generally consider the risk characteristics of the controls for each financial reporting element, rather than making a single judgment for all controls at that location when deciding whether the nature and extent of evidence is sufficient.

### B. Reporting Considerations

#### 1. Evaluation of Control Deficiencies

In order to determine whether a control deficiency, or combination of control deficiencies, is a material weakness, management evaluates each control deficiency that comes to its attention.<sup>73</sup> Control deficiencies that are determined to be a material weakness must be disclosed in management's annual report on its assessment of the effectiveness of ICFR.<sup>74</sup> Management

<sup>73</sup> Because of the importance to investors of the reconciliation to U.S. GAAP, when management of foreign private issuers that file in home country GAAP or IFRS determine the severity of an identified control deficiency, management should consider the impact of the control deficiency to the U.S. GAAP reconciliation disclosure. Hence, management should take into consideration both the amounts reported in the primary financial statements and the amounts reported in the reconciliation to U.S. GAAP in evaluating the severity of the control deficiency. For example, it would be inappropriate to determine, without further consideration, that a control deficiency associated with an item included in the reconciliation to U.S. GAAP, is not material to the primary financial statements, and therefore cannot be, by definition, a material weakness.

<sup>74</sup> Pursuant to Rules 13a-14 and 15d-14 management discloses to the auditors and to the audit committee of the board of directors (or persons fulfilling the equivalent function) all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls. The interaction of qualitative considerations that affect ICFR with quantitative considerations ordinarily results in deficiencies in

may not disclose that it has assessed ICFR as effective if there is one or more control deficiencies determined to be a material weakness in ICFR. As part of the evaluation of ICFR, management considers whether the deficiencies, individually or in combination, are material weaknesses as of the end of the fiscal year. Multiple control deficiencies that affect the same financial statement account balance or disclosure increase the likelihood of misstatement and may, in combination, constitute a material weakness if there is a reasonable possibility<sup>75</sup> that a material misstatement to the financial statements would not be prevented or detected in a timely manner, even though such deficiencies may be individually insignificant. Therefore, management should evaluate individual control deficiencies that affect the same account balance, disclosure, relevant assertion, or component of internal control, to determine whether they collectively result in a material weakness.<sup>76</sup>

The evaluation of a control deficiency should include both quantitative and qualitative factors. Management can evaluate a deficiency in ICFR by considering the likelihood that the company's ICFR will fail to prevent or detect a misstatement of a financial statement element, or component thereof, on a timely basis; and the magnitude of the potential misstatement resulting from the deficiency or deficiencies. This evaluation is based on whether the company's controls will fail to prevent or detect a misstatement on a timely basis, not necessarily on whether a misstatement actually has occurred.

Several factors affect the likelihood that a deficiency, or a combination of deficiencies, will result in a misstatement in a financial reporting element not being prevented or detected on a timely basis. The factors include, but are not limited to, the following:

the following areas being at least significant deficiencies in internal control over financial reporting: Controls over the selection and application of accounting policies that are in conformity with generally accepted accounting principles; antifraud programs and controls; controls over non-routine and non-systematic transactions; and controls over the period-end financial reporting process. If management determines that the deficiency would prevent prudent officials in the conduct of their own affairs from concluding that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with generally accepted accounting principles, then management should deem the deficiency to be at least a significant deficiency.

<sup>75</sup> See footnote 32.

<sup>76</sup> A similar approach to aggregating individually insignificant control deficiencies was used by the AICPA in Statement on Auditing Standard No. 112.

<sup>68</sup> See footnote 58 for references to Concept Release comment letters requesting guidance on documentation.

<sup>69</sup> *Id.*

<sup>70</sup> *Id.*

<sup>71</sup> Guidance in this area was requested in numerous comments received in response to the Concept Release. See, for example, letters regarding file number S7-11-06 of Eli Lilly, Deloitte & Touche LLP, Ernst & Young LLP, Sasol Group, and the Institute of Management Accountants at <http://www.sec.gov/comments/s7-11-06/s71106.shtml>.

- The nature of the financial statement elements, or components thereof, involved (e.g., suspense accounts and related party transactions involve greater risk);

- The susceptibility of the related asset or liability to loss or fraud (i.e., greater susceptibility increases risk);

- The subjectivity, complexity, or extent of judgment required to determine the amount involved (i.e., greater subjectivity, complexity, or judgment, like that related to an accounting estimate, increases risk);

- The interaction or relationship of the control with other controls (i.e., the interdependence or redundancy of the control);

- The interaction of the deficiencies (i.e., when evaluating a combination of two or more deficiencies, whether the deficiencies could affect the same financial statement accounts and assertions); and

- The possible future consequences of the deficiency.

Management should evaluate how the controls interact with other controls when evaluating the likelihood that the company's controls will fail to prevent or detect on a timely basis a misstatement that is material to the company's financial statements. There are controls, such as general IT controls, on which other controls depend. Some controls function together as a group of controls. Other controls overlap, in the sense that more than one control may individually achieve the same objective.

Several factors affect the magnitude of the misstatement that might result from a deficiency or deficiencies in controls. The factors include, but are not limited to, the following:

- The financial statement amounts or total of transactions exposed to the deficiency; and

- The volume of activity in the account balance or class of transactions exposed to the deficiency that has occurred in the current period or that is expected in future periods.

In evaluating the magnitude of the potential misstatement to the company's financial statements as a whole, management should recognize that the maximum amount that an account balance or total of transactions can be overstated is the recorded amount, while understatements could be larger. Moreover, in many cases, the probability of a small misstatement will be greater than the probability of a large misstatement. For example, if the deficiency is that errors identified during an account reconciliation are not being investigated in a timely manner, management should consider the possibility that larger errors are more

likely to be investigated or identified through other controls than smaller ones.

Management should evaluate the effect of compensating controls<sup>77</sup> when determining whether a control deficiency or combination of deficiencies is a material weakness. When evaluating a deficiency in ICFR, management also should determine the level of detail and degree of assurance that would satisfy prudent officials in the conduct of their own affairs that they have reasonable assurance that transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP.

The following circumstances are strong indicators that a material weakness in ICFR exists:

- An ineffective control environment.

Circumstances that may indicate that the company's control environment is ineffective include, but are not limited to:

- Identification of fraud of any magnitude on the part of senior management.
- Significant deficiencies that have been identified and remain unaddressed after some reasonable period of time.
- Ineffective oversight of the company's external financial reporting and ICFR by the company's audit committee.<sup>78</sup>
  - Restatement of previously issued financial statements to reflect the correction of a material misstatement.

**Note:** The correction of a material misstatement includes misstatements due to error or fraud; it does not include retrospective application of a change in accounting principle to comply with a new accounting principle or a voluntary change from one generally accepted accounting principle to another generally accepted accounting principle.

- Identification by the auditor of a material misstatement in financial statements in the current period under circumstances that indicate the misstatement would not have been discovered by the company's ICFR.

<sup>77</sup> Compensating controls are controls that serve to accomplish the objective of another control that did not function properly, helping to reduce risk to an acceptable level. To have a mitigating effect, the compensating control should operate at a level of precision that would prevent or detect a misstatement that was material.

<sup>78</sup> If no audit committee exists, all references to the audit committee apply to the entire board of directors of the company. When a company is not required by law or applicable listing standards to have independent directors on its audit committee, the lack of independent directors at these companies is not indicative, by itself, of a control deficiency. In all cases, management should interpret the terms "board of directors" and "audit committee" as being consistent with provisions for the use of those terms as defined in relevant SEC rules.

- For complex entities in highly regulated industries, an ineffective regulatory compliance function. This relates solely to those aspects of the ineffective regulatory compliance function in which associated violations of laws and regulations could have a material effect on the reliability of financial reporting.

## 2. Expression of Assessment of Effectiveness of ICFR by Management and the Registered Public Accounting Firm

Management should disclose a clear expression of its assessment related to the effectiveness of ICFR and, therefore, should not qualify its assessment by saying that the company's ICFR is effective subject to certain qualifications or exceptions or express similar positions. For example, management should not state that the company's controls and procedures are effective except to the extent that certain material weakness(es) have been identified. In addition, if a material weakness exists, management may not state that the company's ICFR is effective. However, management may state that controls are ineffective due solely to, and only to the extent of, the identified material weakness(es). Prior to making this statement, however, management should consider the nature and pervasiveness of the material weakness. In addition, management may disclose any remediation efforts to the identified material weakness(es) in Item 9A of Form 10-K, Item 15 of Form 20-F, or General Instruction B of Form 40-F.

## 3. Disclosures About Material Weaknesses

The Commission's rule implementing Section 404 was intended to bring information about material weaknesses in ICFR into public view. Because of the significance of the disclosure requirements surrounding material weaknesses beyond specifically stating that the material weaknesses exist, companies should also consider including the following in their disclosures:<sup>79</sup>

- 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 to form an

<sup>79</sup> Significant deficiencies in ICFR are not required to be disclosed in management's annual report on its evaluation of ICFR required by Item 308(a).

overall picture that is not misleading.<sup>80</sup> 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. While management is required to conclude and state in its report that ICFR is ineffective when there is one or more material weaknesses, companies should also consider providing disclosure that allows investors to understand the root cause of the control deficiency and to assess the potential impact of each particular material weakness. This disclosure will 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 ICFR from those material weaknesses that do not. The goal underlying all disclosure in this area is to provide an investor with disclosure and analysis beyond the mere existence of a material weakness.

#### 4. Impact of a Restatement of Previously Issued Financial Statements on Management's Report on ICFR

Item 308 of Regulation S-K requires disclosure of management's assessment of the effectiveness of the company's ICFR as of the end of the company's most recent fiscal year. When a material misstatement in previously issued financial statements is discovered, a company is required to restate those financial statements. However, the restatement of financial statements does not, by itself, necessitate that management consider the effect of the restatement on the company's prior conclusion related to the effectiveness of ICFR.

While there is no requirement for management to reassess or revise its conclusion related to the effectiveness of ICFR, management should consider whether its original disclosures are still appropriate and should modify or supplement its original disclosure to include any other material information that is necessary for such disclosures not to be misleading in light of the restatement. The company should also disclose any material changes to ICFR, as required by Item 308(c) of Regulation S-K.

Similarly, while there is no requirement that management reassess or revise its conclusion related to the effectiveness of its disclosure controls and procedures, management should

consider whether its original disclosures regarding effectiveness of disclosure controls and procedures need to be modified or supplemented to include any other material information that is necessary for such disclosures not to be misleading. With respect to the disclosures concerning ICFR and disclosure controls and procedures, the company may need to disclose in this context what impact, if any, the restatement has on its original conclusions regarding effectiveness of ICFR and disclosure controls and procedures.

#### 5. Inability To Assess Certain Aspects of ICFR

In certain circumstances, management may encounter difficulty in assessing certain aspects of its ICFR. For example, management may outsource a significant process to a service organization and determine that evidence of the operating effectiveness of the controls over that process is necessary. However, the service organization may be unwilling to provide either a Type 2 SAS 70 report or to provide management access to the controls in place at the service organization so that management could assess effectiveness.<sup>81</sup> Finally, management may not have compensating controls in place that allow a determination of the effectiveness of the controls over the process in an alternative manner. The Commission's disclosure requirements state that management's annual report on ICFR must include a statement as to whether or not ICFR is effective and do not permit management to issue a report on ICFR with a scope limitation.<sup>82</sup> Therefore, management must determine whether the inability to assess controls over a particular process is significant enough to conclude in its report that ICFR is not effective.

#### Request for Comment

We request and encourage any interested parties to submit comments

<sup>81</sup> AU Sec. 324, *Service Organizations* (as adopted on an interim basis by the PCAOB in PCAOB Rule 3200T), defines a report on controls placed in operation and test of operating effectiveness, commonly referred to as a "Type 2 SAS 70 report." This report is a service auditor's report on a service organization's description of the controls that may be relevant to a user organization's internal control as it relates to an audit of financial statements, on whether such controls were suitably designed to achieve specified control objectives, on whether they had been placed in operation as of a specific date, and on whether the controls that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified.

<sup>82</sup> See Item 308 of Regulations S-K and S-B [17 CFR 229.308(a)(3) and 228.308(a)(3)].

on the proposed interpretive guidance. In addition to seeking general feedback on the proposed interpretive guidance, the Commission seeks comments on the following:

- Will the proposed interpretive guidance be helpful to management in completing its annual evaluation process? Does the proposed guidance allow for management to conduct an efficient and effective evaluation? If not, why not?
- Are there particular areas within the proposed interpretive guidance where further clarification is needed? If yes, what clarification is necessary?
- Are there aspects of management's annual evaluation process that have not been addressed by the proposed interpretive guidance that commenters believe should be addressed by the Commission? If so, what are those areas and what type of guidance would be beneficial?
- Do the topics addressed in the existing staff guidance (May 2005 Staff Guidance and Frequently Asked Questions (revised October 6, 2004)) continue to be relevant or should such guidance be retracted? If yes, which topics should be kept or retracted?
- Will the proposed guidance require unnecessary changes to evaluation processes that companies have already established? If yes, please describe.
- Considering the PCAOB's proposed new auditing standards, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Considering and Using the Work of Others In an Audit*, are there any areas of incompatibility that limit the effectiveness or efficiency of an evaluation conducted in accordance with the proposed guidance? If so, what are those areas and how would you propose to resolve the incompatibility?
- Are there any definitions included in the proposed interpretive guidance that are confusing or inappropriate and how would you change the definitions so identified?
- Will the guidance for disclosures about material weaknesses result in sufficient information to investors and if not, how would you change the guidance?
- Should the guidance be issued as an interpretation or should it, or any part, be codified as a Commission rule?
- Are there any considerations unique to the evaluation of ICFR by a foreign private issuer that should be addressed in the guidance? If yes, what are they?

<sup>80</sup> See Exchange Act Rule 12b-20 [17 CFR 240.12b-20].

#### IV. Proposed Rule Amendments

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, 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 ICFR.<sup>83</sup> We are proposing to amend these rules to state that, although there are many different ways to conduct an evaluation of the effectiveness of ICFR to meet the requirement in the rule, an evaluation conducted in accordance with the interpretive guidance issued by the Commission, if the Commission adopts the interpretive guidance in final form, would satisfy the annual management evaluation required by those rules.<sup>84</sup> The proposed amendments would not limit the ability of management to use its judgment to determine a method of evaluation that is appropriate for its company. The proposed amendments would be similar to a non-exclusive safe-harbor in that they would not require management to conduct the evaluation in accordance with the interpretive guidance, but would provide certainty to management that chooses to follow the guidance that it has satisfied its obligation to conduct an evaluation for purposes of the requirements in Rules 13a-15(c) and 15d-15(c).

Our rules implementing Section 404(b) of Sarbanes-Oxley require every registered public accounting firm that issues or prepares an audit report on a company's financial statements for inclusion in an annual report that contains an assessment by management of the effectiveness of the registrant's ICFR to attest to, and report on, such assessment. Pursuant to Rule 2-02(f), the accountant's attestation report must 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." Over the past three years we have received feedback that the current form of the auditor's opinion

may not effectively communicate the auditor's responsibility in relation to management's evaluation process. Therefore, we are proposing to revise Rule 2-02(f) to require the auditor to express an opinion directly on the effectiveness of ICFR. In addition, we are proposing revisions to Rule 2-02(f) to clarify the circumstances in which we would expect that the accountant cannot express an opinion.

We are also proposing conforming revisions to the definition of attestation report in Rule 1-02(a)(2) of Regulation S-X. We believe this opinion necessarily conveys whether management's assessment is fairly stated. We understand the PCAOB will be proposing a conforming revision to its auditing standard to reflect this revision as well.

#### *Request for Comment*

We request and encourage any interested person to submit comments on the proposed revision to Exchange Act Rules 13a-15(c) and 15d-15(c) and Rules 1-02 and 2-02 of Regulation S-X. In addition to seeking general feedback on the proposed rule revision, the Commission seeks comments on the following:

- Should compliance with the interpretive guidance, if issued in final form, be voluntary, as proposed, or mandatory?
- Is it necessary or useful to amend the rules if the proposed interpretive guidance is issued in final form, or are rule revisions unnecessary?
- Should the rules be amended in a different manner in view of the proposed interpretive guidance?
  - Is it appropriate to provide the proposed assurance in Rules 13a-15 and 15d-15 that an evaluation conducted in accordance with the interpretive guidance will satisfy the evaluation requirement in the rules?
  - Does the proposed revision offer too much or too little assurance to management that it is conducting a satisfactory evaluation if it complies with the interpretive guidance?
  - Are the proposed revisions to Exchange Act Rules 13a-15(c) and 15d-15(c) sufficiently clear that management can conduct its evaluation using methods that differ from our interpretive guidance?
  - Do the proposed revisions to Rules 1-02(a)(2) and 2-02(f) of Regulation S-X effectively communicate the auditor's responsibility? Would another formulation better convey the auditor's role with respect to management's assessment and/or the auditor's reporting obligation?

- Should we consider changes to other definitions or rules in light of these proposed revisions?

- The proposed revision to Rule 2-02(f) highlights that disclaimers by the auditor would only be appropriate in the rare circumstance of a scope limitation. Does this adequately convey the narrow circumstances under which an auditor may disclaim an opinion under our proposed rule? Would another formulation provide better guidance to auditors?

#### 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 that we are proposing 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

##### *A. Background*

Section 404(a) of Sarbanes-Oxley directed the Commission to prescribe rules to require each annual report that a company, other than a registered investment company, files pursuant to Exchange Act Section 13(a) or 15(d) to contain an internal control report: (1) Stating management's responsibilities 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. On June 5, 2003, the Commission adopted final rules implementing the requirements of Section 404(a).<sup>85</sup>

The final rules did not prescribe any specific method or set of procedures for management to follow in performing its evaluation of ICFR. This gave managers some flexibility, while leaving it to management's judgment about what constitutes "reasonable support" for its assessment of internal controls. In the absence of specific guidance, managers of many companies have relied upon AS No. 2. This choice reflected the pressure on managers to meet the expectations of the auditors who were charged with

<sup>83</sup> We recently adopted amendments that, among other things, provide a transition period for newly public companies before they become subject to the ICFR requirements. Under the new amendments, a newly public company will not become subject to the ICFR requirements until it either had been required to file an annual report for the prior fiscal year with the Commission or had filed an annual report with the Commission for the prior fiscal year. See Release No. 33-8760 (December 15, 2006) available at <http://www.sec.gov/rules/final.shtml>.

<sup>84</sup> See proposed revisions to Rules 13a-15(c) and 15d-15(c).

<sup>85</sup> See footnote 9 above for reference.

attesting to the effectiveness of the company's ICFR and management's annual assessment of ICFR. The limited alternative guidance available to management has not given it the information that is necessary to assuage its concerns about the risk of being unable to satisfy the expectations of its auditor under AS No. 2.

The proposed interpretive guidance is intended to enable management to conduct a more effective and efficient evaluation of ICFR. Further, under the proposed rule amendments, the auditor would express only a single opinion on the effectiveness of the company's internal controls in its attestation report rather than expressing separate opinions directly on the effectiveness of the company's ICFR and on management's assessment.

Managers may choose to rely on the interpretive guidance, as an alternative to what is provided in existing auditing standards or elsewhere, for two key reasons. First, we are proposing a rule that would give managers who follow the interpretive guidance comfort that they have conducted a sufficient ICFR evaluation. Second, elimination of the auditor's opinion on management's assessment of ICFR in the auditor's attestation report should significantly lessen, if not eliminate, the pressures that managers have felt to look to auditing standards for guidance in performing those evaluations.

While the focus of the Cost-Benefit Analysis in this release is on the costs and benefits related to the rule amendments that we are proposing in this release, rather than the costs and benefits of the proposed interpretive guidance that we describe in this release,<sup>86</sup> in view of the fact that the effect of the proposed rule amendments will be to endorse the interpretive guidance as one approach to compliance, we also have considered

<sup>86</sup> To reduce the costs of implementation, we developed proposed interpretive guidance to aid management in the planning and performance of an evaluation of ICFR. In connection with this interpretive guidance, we are proposing an amendment to Exchange Act Rules 13a-15(c) and 15d-15(c) that would make it clear that an evaluation that is conducted in accordance with the interpretive guidance is one way to satisfy the annual management evaluation requirement in those rules and forms. In addition, we are proposing revisions to Rule 2-02(f) of Regulation S-X to indicate that an auditor should only express a single opinion directly on the effectiveness of a company's ICFR, rather than an opinion on the effectiveness and a separate opinion on management's assessment. We are also proposing conforming revisions to Rule 1-02(a)(2) of Regulation S-X which defines the term "attestation report on management's assessment of internal control over financial reporting."

the effect that the proposed guidance may have on evaluation costs.

By encouraging managers to rely on guidance that is less prescriptive and better aligned with the objectives of Section 404, the proposed rule should reduce management's effort relative to current practice under existing auditing standards. The expenditure of effort by audit firms also may decline, in response, relative to what would occur otherwise. We are thus soliciting comments on how the proposed guidance and the proposed new auditing standard will affect the expenditure of effort, and division of labor, between the managers and employees of public companies and their audit firms.

The benefits and costs of the proposed rule amendments will be affected by the number of companies that choose to follow the interpretive guidance. Managers will be free to weigh the benefits and costs to shareholders in choosing whether to follow the guidance or some other approach. This feature does not apply to the proposed revisions to Regulation S-X, however, because compliance with these amendments will be mandatory.

#### B. Benefits

As explained above, the proposed amendments would state that an evaluation by management of ICFR that is conducted in accordance with the interpretive guidance is one of many ways to satisfy the evaluation requirement in Exchange Act Rules 13a-15(c) and 15d-15(c), and would clarify that the auditor should only express an opinion directly on the effectiveness of a company's ICFR. We expect the primary benefits of the proposed rule amendments to Exchange Act Rules 13a-15(c) and 15d-15(c) to be two-fold. First, there will be a greater likelihood that management choosing to follow the guidance will more effectively detect material weaknesses. Second, there should be a reduction in the costs of excessive testing and documentation that have arisen from management aversion to risk in determining the level and type of effort that is sufficient to conduct an evaluation of ICFR. We believe the proposed revisions to Rule 2-02(f) of Regulation S-X should better communicate to investors the nature of the assurance provided to them through the work performed by the auditor.

The proposed amendments to Rules 13a-15(c) and 15d-15(c) are similar to a non-exclusive safe-harbor in that they would not require management to comply with the evaluation requirement in a particular manner (*i.e.*, by following the interpretive guidance), but would

provide certainty to management choosing to follow the guidance that management has satisfied its obligation to conduct an evaluation in an appropriate manner.

The proposed rule amendments are intended to make implementation of the internal control reporting requirements more efficient and cost-effective for all registrants. We believe that benefits to investors will arise from the following potential consequences of the proposed rule amendments:

- Management can choose to follow guidance that is an efficient and effective means of satisfying the evaluation requirement;
- All public companies, especially smaller public companies, that choose to follow the guidance would be afforded considerable flexibility to scale and tailor their evaluation methods and procedures to fit their own facts and circumstances;
- Management would have the comfort that an evaluation that complies with our interpretive guidance is one way to satisfy the evaluation required by Exchange Act Rule 13a-15(c) and Exchange Act Rule 15d-15(c), and reduce any second-guessing as to whether management's process was adequate;
- There may be reduced risk of costly and time-consuming disagreement between the auditor and management regarding the extent of documentation and testing needed to satisfy the ICFR evaluation requirement;
- Companies are likely to save costs and reduce the amount of effort and resources associated with an evaluation by relying on a set of guidelines that clarify the nature, timing and extent of management's procedures and that recognizes the many different types of evidence-gathering methods available to management (such as direct interaction with control components);<sup>87</sup> and
- Management would have greater clarity regarding the Commission's expectations concerning an evaluation of ICFR.

Improved implementation of the ICFR requirements could facilitate a more timely flow of information within the company and, ultimately, to investors and the marketplace. We believe that an effective internal control evaluation would help management to better identify potential weaknesses and inefficiencies that could result in cost-savings in a company's operations.

<sup>87</sup> See, *e.g.*, transcript of Roundtable Discussion on Second Year Experiences with Internal Control Reporting and Auditing Provisions, May 10, 2006, available at <http://www.sec.gov/spotlight/soxcomp.htm>.

### C. Costs

Some larger public companies may face a transitory increase in compliance costs if they choose to follow the guidance. This is because many of the larger companies that have already evaluated their internal controls have reported cost reductions, or the anticipation of cost reductions, in the second and subsequent years of compliance with the internal control reporting provisions. For companies that choose to follow the interpretive guidance, the proposed rule amendments may cause some accelerated and large accelerated filers who have completed one or more evaluations of their ICFR to adjust their evaluation procedures in order to take advantage of the proposed rule amendments which could lead to an increase in the compliance costs.<sup>88</sup>

In addition, the benefits of the proposed amendments may be partially offset if the company's auditor obtains more audit evidence directly itself rather than using evidence generated by management's evaluation process, which could lead to an increase in audit costs.<sup>89</sup>

### D. Request for Comment

We request comment on the nature of the costs and benefits of the proposed amendments, including the likely responses of public companies and auditors concerning the introduction of new management guidance. We seek evidentiary support for the conclusions on the nature and magnitude of those costs and benefits, including data to quantify the costs and the value of the benefits described above. We seek estimates of these costs and benefits, as well as any costs and benefits not already identified, that may result from the adoption of these proposed amendments and issuance of interpretive guidance. With increased reliance on management judgment, will there be unintended consequences? We also request qualitative feedback and related evidentiary support relating to any benefits and costs we may have overlooked.

<sup>88</sup> Presumably such companies would only adjust their evaluation methods if they perceived the benefit of the proposed amendments would exceed the increased compliance cost.

<sup>89</sup> Any near term increase in audit costs may be mitigated if the PCAOB's proposed new auditing standards, *An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements and Considering and Using the Work of Others In an Audit*, are approved.

### VII. 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,"<sup>90</sup> we solicit data to determine whether the proposed rule amendments 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.

Section 3(f) of the Exchange Act<sup>91</sup> requires the Commission, whenever it engages in rulemaking, and is required to consider or determine if an action is necessary or appropriate in the public interest, also to consider whether the action will promote efficiency, competition, and capital formation. Section 23(a)(2) of the Exchange Act<sup>92</sup> also requires us, when adopting rules under the Exchange Act, to consider the impact that any new rule would have on competition. 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.

We believe the proposed amendments, if adopted, would promote competition, efficiency, and capital formation. Under the Sarbanes-Oxley Act, all companies, except registered investment companies, are subject to the requirement to conduct an evaluation of their ICFR. Compliance with the proposed amendments to Exchange Act Rules 13a-15 and 15d-15, however, would be voluntary rather than mandatory and, as such, companies could choose whether or not to follow the interpretive guidance. The rule therefore should not impose any new cost. Accordingly, companies that have already completed one or more evaluations can continue to use their existing procedures to satisfy the evaluation required by our rules, or companies can choose to follow the guidance.

The proposed rule amendments should increase the efficiency with respect to the effort and resources associated with an evaluation of ICFR and facilitate more efficient allocation of

resources within a company. The guidance is also designed to be scalable depending on the size of the company. Reducing the potentially disproportionate costs to smaller companies required to comply with the evaluation requirements should also increase efficiency. Finally, the rules may promote competition among companies in developing the most efficient means to satisfy the evaluation requirement.

Capital formation may be promoted in the following ways. To the extent the cost of compliance with the evaluation requirement is lowered to a more economically feasible threshold, smaller private companies may be able to access public capital markets earlier in their growth. They may therefore obtain enhanced sources of capital at lower cost.

The proposed amendments may also introduce new competition from outside professionals and software vendors in the supply of services and products to assist the managers of public companies in their evaluations of ICFR. We seek comment on whether the proposed guidance and accompanying rule would stimulate new entry into any such market.

We request comment on the potential impact of the proposed amendments on the U.S. economy on an annual basis, any potential increase in costs or prices for consumers or individual industries, and any potential effect on competition, investment or innovation. We also request comment on whether the proposed amendments would promote efficiency, competition, and capital formation. Commenters are requested to provide empirical data and other factual support for their view to the extent possible.

### VIII. Initial Regulatory Flexibility Analysis

This Initial Regulatory Flexibility Analysis ("IRFA") has been prepared in accordance with the Regulatory Flexibility Act.<sup>93</sup> This IRFA involves proposed amendments to Exchange Act Rules 13a-15(c) and 15d-15(c) and Rules 1-02(a)(2) and 2-02(f) of Regulation S-X. These rules require the management of an Exchange Act reporting company, other than registered investment companies, to prepare an annual evaluation of the company's ICFR, and that the registered public accounting firm that issues an audit report on the company's financial statements to attest to, and report on, management's assessment. The proposed rule amendments would

<sup>90</sup> 5 U.S.C. 603.

<sup>91</sup> 15 U.S.C. 78c(f).

<sup>92</sup> 15 U.S.C. 78w(a)(2).

<sup>93</sup> 5 U.S.C. 601.

clarify that an evaluation that is conducted in accordance with the interpretive guidance would satisfy the annual management evaluation of the company's ICFR.<sup>94</sup>

#### A. Reasons for the Proposed Action

We are proposing rule amendments that would make it clear that an evaluation conducted in accordance with our interpretive guidance is one of many ways to satisfy the requirements of Exchange Act Rules 13a-15(c) and 15d-15(c), clarify the auditor report required Rule 2-02(f) of Regulation S-X, and revise the definition of the term attestation report in Rule 1-02(a)(2) of Regulation S-X.

#### B. Objectives

The proposed rule amendments are intended to make implementation of the internal control reporting requirements more efficient and cost-effective by reducing ambiguities that have arisen due to the lack of certainty available to companies on how to conduct an annual evaluation of ICFR.

#### C. Legal Basis

We are issuing the proposed rule amendments under the authority set forth in Sections 12, 13, 15 and 23 of the Exchange Act, and Sections 3(a) and 404 of the Sarbanes-Oxley Act of 2002.

#### D. Small Entities Subject to the Proposed Revisions

The proposed amendments would affect some issuers that are small entities. Exchange Act Rule 0-10(a)<sup>95</sup> 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 registered investment companies, that may be considered small entities. The proposed amendments would apply to any small entity that is subject to Exchange Act reporting requirements.

#### E. Reporting, Recordkeeping, and Other Compliance Requirements

The proposed rule amendments would not impose any new reporting, recordkeeping or compliance requirements. The amendments provide

a voluntary, non-exclusive certainty, in the nature of a safe-harbor.

#### F. Duplicative, Overlapping, or Conflicting Federal Rules

The proposed amendments do not duplicate, overlap, or conflict with other federal rules.

#### G. Significant Alternatives

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 proposed extension, 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.

The proposed rule amendments should allow a company to conduct an evaluation of internal control with greater certainty that it has satisfied our rule. We believe the proposed rule change would affect both large and small entities equally. The proposed rule amendments set forth primarily performance standards to aid companies in conducting an evaluation of ICFR. The purpose of the proposed amendments is to give comfort that following the clarified, consolidated and simplified guidance will satisfy the evaluation requirement. The proposed rule is designed to afford small entities that choose to rely on the interpretive guidance the flexibility to scale and tailor their evaluation methods to fit their particular circumstances. We are not proposing an exemption for small entities, because we are not persuaded at this time that an exemption would further the primary goal of the Sarbanes-Oxley Act to enhance the quality of reporting and increasing investor confidence in the fairness and integrity of the securities markets.

#### H. Solicitation of Comments

We encourage the submission of comments with respect to any aspect of this Initial Regulatory Flexibility Analysis. In particular, we request comments regarding:

- The number of small entity issuers that may be affected by the proposed extension;
- The existence or nature of the potential impact of the proposed

amendments on small entity issuers discussed in the analysis; and

- How to quantify the impact of the proposed amendments.

Respondents are asked to describe the nature of any impact and provide empirical data supporting the extent of the impact. Such comments will be considered in the preparation of the Final Regulatory Flexibility Analysis, if the proposed rule amendments are adopted, and will be placed in the same public file as comments on the proposed amendments themselves.

#### IX. Statutory Authority and Text of Proposed Rule Amendments

The amendments described in this release are being proposed under the authority set forth in Sections 12, 13, 15, 23 of the Exchange Act, and Sections 3(a) and 404 of the Sarbanes-Oxley Act.

#### List of Subjects

##### 17 CFR Part 210

Accountants, Accounting, Reporting and recordkeeping requirements, Securities.

##### 17 CFR Part 240

Reporting and recordkeeping requirements, Securities.

##### 17 CFR Part 241

Securities.

#### Text of Amendments

For the reasons set out in the preamble, the Commission proposes to amend 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, 80a-8, 80a-20, 80a-29, 80a-30, 80a-31, 80a-37(a), 80b-3, 80b-11, 7202 and 7262, unless otherwise noted.

2. Amend § 210.1-02 by revising paragraph (a)(2) to 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*

<sup>94</sup> In connection with the proposed rule amendments, we are also proposing interpretive guidance for management to use in conducting an annual evaluation of the company's internal control over financial reporting. The proposed interpretive guidance itself is not subject to the Regulatory Flexibility Act. Accordingly, for purposes of the IRFA, our analysis is focused on the proposed rule amendments.

<sup>95</sup> 17 CFR 240.0-10(a).

*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, either unqualified or adverse, as to whether the registrant maintained, in all material respects, effective internal control over financial reporting (as defined in § 240.13a-15(f) or 240-15d-15(f)), except in the rare circumstance of a scope limitation that cannot be overcome by the registrant or the registered public accounting firm which would result in the accounting firm disclaiming an opinion.

\* \* \* \* \*

3. Amend § 210.2-02 by revising paragraph (f) to read as follows:

**§ 210.2-02 Accountants' reports and attestation reports.**

\* \* \* \* \*

(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, indicate that the accountant has audited management's assessment, and clearly state the opinion of the accountant, either unqualified or adverse, as to whether the registrant maintained, in all material respects, effective internal control over financial reporting, except in the rare circumstance of a scope limitation that cannot be overcome by the registrant or the registered public accounting firm which would result in the accounting firm disclaiming an opinion. The attestation report on management's assessment of internal control over financial reporting may be separate from the accountant's report.

\* \* \* \* \*

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

4. The authority citation for Part 240 continues 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, 80a-20, 80a-23, 80a-29, 80a-37, 80b-3, 80b-4, 80b-11, and 7201 *et seq.*, and 18 U.S.C. 1350, unless otherwise noted.

\* \* \* \* \*

5. Amend § 240.13a-15 by revising paragraph (c) to read as follows:

**§ 240.13a-15 Controls and procedures.**

\* \* \* \* \*

(c) The management of each such issuer, that either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Act (15 U.S.C. 78m(a) or 78o(d)) for the prior fiscal year or previously had filed an annual report with the Commission for the prior fiscal year, 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. Although there are many different ways to conduct an evaluation of the effectiveness of internal control over financial reporting to meet the requirements of this paragraph, an evaluation that is conducted in accordance with the interpretive guidance issued by the Commission in Release No. 34-XXXXX will satisfy the evaluation required by this paragraph.

\* \* \* \* \*

6. Amend § 240.15d-15 by revising paragraph (c) to read as follows:

**§ 240.15d-15 Controls and procedures.**

\* \* \* \* \*

(c) The management of each such issuer, that either had been required to file an annual report pursuant to section 13(a) or 15(d) of the Act (15 U.S.C. 78m(a) or 78o(d)) for the prior fiscal year or previously had filed an annual report with the Commission for the prior fiscal year, 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. Although there are many different ways to conduct an evaluation of the effectiveness of internal control over financial reporting to meet the requirements of this paragraph, an evaluation that is conducted in accordance with the interpretive guidance issued by the Commission in Release No. 34-XXXXX will satisfy the evaluation required by this paragraph.

\* \* \* \* \*

**PART 241—INTERPRETATIVE RELEASES RELATING TO THE SECURITIES EXCHANGE ACT OF 1934 AND GENERAL RULES AND REGULATIONS THEREUNDER**

7. Part 241 is amended by adding Release No. 34-XXXXX and the release date of December XX, 2006 to the list of interpretative releases.

Dated: December 20, 2006.

By the Commission.

Nancy M. Morris,  
Secretary.

[FR Doc. E6-22099 Filed 12-26-06; 8:45 am]

BILLING CODE 8011-01-P

**DEPARTMENT OF THE TREASURY**

**Internal Revenue Service**

**26 CFR Part 1**

[REG-141901-05]

RIN 1545-BE92

**Exchanges of Property for an Annuity**

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Change of location of public hearing.

**SUMMARY:** On October 18, 2006, on page 61441 of the **Federal Register** (71 FR 61441), a notice of proposed rulemaking and notice of public hearing announced that a public hearing concerning guidance on the taxation of the