

each quarterly and annual report filed with the Commission. Section 906 of the Sarbanes-Oxley Act added new Section 1350 to Title 18 of the United States Code,<sup>29</sup> which contains a certification requirement subject to specific federal criminal provisions and that is separate and distinct from the certification requirement mandated by Section 302.<sup>30</sup> On August 28, 2002, we adopted Exchange Act Rules 13a-14 and 15d-14 and Investment Company Act Rule 30a-2 and amended our periodic report forms to implement the statutory directive in Section 302.<sup>31</sup> These rules and amendments became effective on August 29, 2002. On January 27, 2003, we adopted Form N-CSR to be used by registered management investment companies to file certified shareholder reports with the Commission.<sup>32</sup> The provisions added to Title 18 by Section 906 were by their terms effective on enactment of the Sarbanes-Oxley Act.

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

effectively monitor compliance with this certification requirement.

## II. Discussion of Amendments Implementing Section 404

### A. Definition of Internal Control

#### 1. Proposed Rule

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

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

tests of transactions and perform additional analyses in order to accumulate sufficient, competent audit evidence to support its opinion on the financial statements.

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

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

to Section 13 in respect of a security registered pursuant to Section 12, unless the duty to file under Section 15(d) has been suspended for any fiscal year. See Exchange Act Rule 12h-3 [17 CFR 240.12h-3].

<sup>29</sup> 29 U.S.C. 1350.

<sup>30</sup> See Release No. 34-46300 (Aug. 2, 2002) [67 FR 51508] at n. 11, containing supplemental information on the Commission's original certification proposal in light of the enactment of the Sarbanes-Oxley Act of 2002.

<sup>31</sup> See Release No. 33-8124 (Aug. 28, 2002) [67 FR 57276].

<sup>32</sup> See Release No. IC-25914 (Jan. 27, 2003) [68 FR 5348].

<sup>33</sup> See Release No. 33-8212 (Mar. 21, 2003) [68 FR 15600].

<sup>34</sup> These methods have included: (1) Submitting the statement as non-public paper correspondence; (2) submitting the statement as non-public electronic correspondence with the EDGAR filing of the periodic report; (3) submitting the statement under (1) or (2) above supplemented by an Item 9 Form 8-K report so that the statement is publicly available; (4) submitting the statement as an exhibit to the periodic report; and (5) submitting the statement in the text of the periodic report (typically, below the signature block for the report).

<sup>35</sup> We proposed to use this term throughout the rules implementing the annual internal control report requirements of Section 404 of the Sarbanes-Oxley Act, as well as the revised Sarbanes-Oxley Section 302 certification requirements, to complement the defined term "disclosure controls and procedures" referred to in the Section 302 requirements. Congress used the term "internal controls" in Section 302 and "internal control structure and procedures for financial reporting" in Section 404.

<sup>36</sup> For a history of the development of internal control standards, see Steven J. Root, *Beyond COSO—Internal Control to Enhance Corporate Governance* (1998).

<sup>37</sup> In 1941, the Commission adopted amendments to Rules 2-02 and 3-07 of Regulation S-X that formally codified this practice. See Accounting Series Release No. 21 (Feb. 5, 1941) [11 FR 10921].

<sup>38</sup> An early definition for the term appeared in *Internal Control—Elements Of a Coordinated System and Its Importance to Management and the Independent Public Accountant*, a report published in 1949 by the American Institute of Accountants, the predecessor to the American Institute of Certified Public Accountants ("AICPA"). The report defined internal control to mean "the plan of organization and all of the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data, promote operational efficiency, and encourage adherence to prescribed managerial policies." Subsequent definitions of the term attempted to clarify the distinction by labeling the controls relevant to an audit as "internal accounting controls" and the non-accounting controls as "administrative controls." The AICPA officially dropped these distinctions in 1988. See Root, at p. 76.

<sup>39</sup> Title I of Pub. L. 95-213 (1977). Beginning in 1973, as a result of the work of the Office of the Watergate Special Prosecutor, the Commission became aware of a pattern of conduct involving the use of corporate funds for illegal domestic political contributions. A subsequent Commission investigation revealed that instances of undisclosed questionable or illegal corporate payments—both domestic and foreign—were widespread. On May 12, 1976, the Commission submitted to the Senate Banking, Housing and Urban Affairs Committee a report entitled *Report on Questionable and Illegal Corporate Payments and Practices*. The report described and analyzed the Commission's investigation concerning improper corporate payments and outlined legislative and other responses that the Commission recommended to remedy these problems. One of the Commission's recommendations was that Congress enact legislation aimed expressly at enhancing the accuracy of the corporate books and records and the reliability of the audit process.