

system of internal accounting controls sufficient to provide reasonable assurances that:

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

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

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

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

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

2. Comments on the Proposal

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

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

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

⁴⁰ See Exchange Act Section 13(b)(2) [15 U.S.C. 78m(b)(2)].

⁴¹ The Treadway Commission was sponsored by the AICPA, the American Accounting Association, the Financial Executives International (formerly Financial Executives Institute), the Institute of Internal Auditors and the Institute of Management Accountants (formerly the National Association of Accountants). The Treadway Commission's report, the Report of the National Commission on Fraudulent Financial Reporting (Oct. 1987), is available at www.coso.org.

⁴² See COSO, *Internal Control—Integrated Framework* (1992) ("COSO Report"). In 1994, COSO published an addendum to the *Reporting to External Parties* volume of the COSO Report. The addendum discusses the issue of, and provides a vehicle for, expanding the scope of a public management report on internal control to address additional controls pertaining to safeguarding of assets. In 1996, COSO issued a supplement to its original framework to address the application of internal control over financial derivative activities.

⁴³ Auditing Standards Board, AICPA, Statement on Auditing Standards No. 78, *Consideration of Internal Control in a Financial Statement Audit: An Amendment to Statement on Auditing Standards No. 55* (1995).

⁴⁴ See letters regarding File No. S7-40-02 of: America's Community Bankers ("ACB"); American Corporate Counsel Association ("ACCA"); American Institute of Certified Public Accountants ("AICPA"); Compass Bancshares, Inc. ("Compass"); Computer Sciences Corporation ("CSC"); the Edison Electric Institute ("EEI"); the Independent Community Bankers of America ("ICBA"); the Institute of Internal Auditors ("IIA"); the Association of the Bar of the City of New York, Committee on Corporate Law ("NYCB-CCL"); Protiviti; and Siemens AG.

⁴⁵ See letters regarding File No. S7-40-02 of ACB and ICBA.

⁴⁶ See letters regarding File No. S7-40-02 of: the American Bar Association, Committee on the Federal Regulation of Securities and the Committee on Law and Accounting ("ABA"); the Federal Reserve Bank of Atlanta ("FED"); IIA; Simon Lorne ("Lorne"); and Pricewaterhouse Coopers LLP ("PwC").

⁴⁷ See ABA letter regarding File No. S7-40-02.

⁴⁸ See letters regarding File No. S7-40-02 of: AICPA; Compass; Deloitte & Touche LLP ("D&T"); IIA; KPMG LLP ("KPMG"); and PwC.