

are outside the boundary of financial reporting.

### 3. Final Rules

After consideration of the comments, we have decided to make several modifications to the proposed amendments. We agree that we should use the term "internal control over financial reporting" in our amendments to implement Section 404, as well as our revisions to the Section 302 certification requirements and forms of certification.<sup>49</sup> Rapidly changing terminology has been one obstacle in the development of an accepted understanding of internal control. The term "internal control over financial reporting" is the predominant term used by companies and auditors and best encompasses the objectives of the Sarbanes-Oxley Act. In addition, by using this term, we avoid having to familiarize investors, companies and auditors with new terminology, which should lessen any confusion that may exist about the meaning and scope of internal control.

The final rules define "internal control over financial reporting" as:

A process designed by, or under the supervision of, the registrant's principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant's board of directors,<sup>50</sup> 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>51</sup>

We recognize that our definition of the term "internal control over financial reporting" reflected in the final rules encompasses the subset of internal controls addressed in the COSO Report that pertains to financial reporting objectives. Our definition does not encompass the elements of the COSO Report definition that relate to effectiveness and efficiency of a company's operations and a company's compliance with applicable laws and regulations, with the exception of compliance with the applicable laws and regulations directly related to the preparation of financial statements, such as the Commission's financial reporting requirements.<sup>52</sup> Our definition is consistent with the description of internal accounting controls in Exchange Act Section 13(b)(2)(B).<sup>53</sup>

Following the general language defining internal control over financial reporting, clauses (1) and (2) include the internal control matters described in Section 103 of the Sarbanes-Oxley Act that the company's registered public accounting firm is required to evaluate in its audit or attestation report.<sup>54</sup> This

language is included to make clear that the assessment of management in its internal control report as to which the company's registered public accounting firm will be required to attest and report specifically covers the matters referenced in Section 103. A few commenters believed that it would cause confusion if the definition of internal control did not acknowledge the objectives set forth in Section 103 of the Sarbanes-Oxley Act. As discussed in Section II.G below, the PCAOB is responsible for establishing the Section 103 standards.

Our definition also includes, in clause (3), explicit reference to assurances regarding use or disposition of the company's assets. This provision is specifically included to make clear that, for purposes of our definition, the safeguarding of assets is one of the elements of internal control over financial reporting and it addresses the supplementation of the COSO Framework after it was originally promulgated. In the absence of our change to the definition, the determination of whether control regarding the safeguarding of assets falls within a company's internal control over financial reporting currently could be subject to varying interpretation.

Safeguarding of assets had been a primary objective of internal accounting control in SAS No. 1. In 1988, the ASB issued Statement of Auditing Standards No. 55 (codified as AU § 319 in the Codification of Statements on Auditing Standards), which replaced AU § 320. SAS No. 55 revised the definition of "internal control" and expanded auditors' responsibilities for considering internal control in a financial statement audit. The prior classification of internal control into the two categories of "internal accounting control" and "administrative control" was replaced with the single term "internal control structure," which consisted of three interrelated components—control environment, the accounting system and control procedures. Under this new

preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with the authorization of management and directors of the company. In the audit report (or attestation report), the registered public accounting firm also must describe, at a minimum, material weaknesses in such internal controls and any material noncompliance found on the basis of such testing. See Sections 103(a)(2)(A)(iii)(I), (II) and (III) of the Sarbanes-Oxley Act. See also, Interim Professional Attestation Standards Rule 3300T, adopted in PCAOB Release No. 2003-006 (Apr. 18, 2003), and approved by the Commission on April 25, 2003.

<sup>49</sup> See new Item 308 of Regulations S-K and S-B, amended Items 1-02 and 2-02 of Regulation S-X; amended Items 307 and 401 of Regulations S-K and S-B; amended Exchange Act Rules 13a-14, 13a-15, 15d-14 and 15d-15; and amended Forms 20-F and 40-F.

<sup>50</sup> The COSO Report states that the composition of a company's board and audit committee, and how the directors fulfill their responsibilities related to the financial reporting process, are key aspects of the company's control environment. An important element of the company's internal control over financial reporting " \* \* \* is the involvement of the board or audit committee in overseeing the financial reporting process, including assessing the reasonableness of management's accounting judgments and estimates and reviewing key filings with regulatory agencies." See COSO Report at 130. The Commission similarly has stated in the past that both a company's management and board have important roles to play in establishing a supportive control environment. In its 1981 Statement of Policy regarding the FCPA, the Commission stated, "In the last analysis, the key to an adequate 'control environment' is an approach on the part of the board and top management which makes clear what is expected and that conformity to these expectations will be rewarded while breaches will be punished." See Release No. 34-17500 (Jan. 29, 1981) [46 FR 11544].

<sup>51</sup> See amended Exchange Act Rules 13a-14(d) and 15d-14(d). The scope of the term "preparation of financial statements in accordance with generally accepted accounting principles" in the definition encompasses financial statements prepared for regulatory reporting purposes.

<sup>52</sup> Codification of Statements on Auditing Standards Section 317 requires auditors to consider a company's compliance with laws and regulations that have a direct and material effect on the financial statements.

<sup>53</sup> 15 U.S.C. 78m(b)(2)(B).

<sup>54</sup> Section 103 of the Sarbanes-Oxley Act requires the PCAOB to establish by rule standards to be used by registered public accounting firms in the preparation and issuance of audit reports. In carrying out this responsibility, the PCAOB must include in the auditing standards that it adopts, among other things: a requirement that each registered public accounting firm describe in each audit report the scope of its testing of the company's internal control structure and procedures performed in fulfilling its internal control evaluation and reporting required by Section 404(b) of the Sarbanes-Oxley Act; present in the audit report (or attestation report) its findings from such testing; and an evaluation of whether the company's internal control structure and procedures: (1) Include maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the company's assets; and (2) provide reasonable assurance that transactions are recorded as necessary to permit