

definition, the safeguarding of assets was no longer a primary objective, but a subset of the control procedures component.⁵⁵ The COSO Report followed this shift in the iteration of safeguarding of assets. The COSO Report states that operations objectives “pertain to effectiveness and efficiency of the entity’s operations, including performance and profitability goals and safeguarding resources against loss.”⁵⁶ However, the report also clarifies that safeguarding of assets can fall within other categories of internal control.⁵⁷

In 1994, COSO published an addendum to the *Reporting to External Parties* volume of the COSO Report. The addendum was issued in response to a concern expressed by some parties, including the U.S. General Accounting Office, that the management reports contemplated by the COSO Report did not adequately address controls relating to safeguarding of assets and therefore would not fully respond to the requirements of the FCPA.⁵⁸ In the

addendum, COSO concluded that while it believed its definition of internal control in its 1992 report remained appropriate, it recognized that the FCPA encompasses certain controls related to safeguarding of assets and that there is a reasonable expectation on the part of some readers of management’s internal control reports that the reports will cover such controls. The addendum therefore sets forth the following definition of the term “internal control over safeguarding of assets against unauthorized acquisition, use or disposition”:

Internal control over safeguarding of assets against unauthorized acquisition, use or disposition is a process, effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the entity’s assets that could have a material effect on the financial statements.

As indicated above, to achieve the desired result and to provide consistency with COSO’s 1994 addendum, we have incorporated this definition into our definition of “internal control over financial reporting.” We are persuaded that this is appropriate given the fact that our definition will be used for purposes of public management reporting, and that the companies that will be subject to the Section 404 requirements also are subject to the FCPA requirements. So, under the final rules, safeguarding of assets as provided is specifically included in our definition of “internal control over financial reporting.”

B. Management’s Annual Assessment of, and Report on, the Company’s Internal Control Over Financial Reporting

1. Proposed Rule

We proposed to amend Item 307 of Regulations S–K and S–B, as well as Forms 20–F and 40–F, to require a company’s annual report to include an internal control report of management containing:

- A statement of management’s responsibility for establishing and maintaining adequate internal controls and procedures for financial reporting;
- The conclusions of management about the effectiveness of the company’s internal controls and procedures for financial reporting based on

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.”

management’s evaluation of those controls and procedures; and

- A statement that the registered public accounting firm that prepared or issued the company’s audit report relating to the financial statements included in the company’s annual report has attested to, and reported on, management’s evaluation of the company’s internal controls and procedures for financial reporting. The proposed amendments did not list any additional disclosure requirements for the management report, but rather would have afforded management the flexibility to tailor the report to fit its company’s particular circumstances.

2. Comments on the Proposal

We received comments from 17 commenters on our proposed annual internal control report requirements. All of these commenters believed, in varying degrees, that we should set forth additional disclosure criteria or standards for the management report. Nine commenters stated that we should provide guidance as to the topics to be addressed in the management report, or specify standards or a common set of internal control objectives to be considered by management when assessing the effectiveness of its company’s internal control over financial reporting to ensure that control objectives are addressed in a consistent fashion.⁵⁹ These commenters believed that consistent standards for management’s report on internal control would help investors to understand and compare the quality of various management internal control reports.

Several commenters also thought that we should require management’s internal control report to include certain recitations that would parallel recitations that the registered public accounting firm would have to make in its report attesting to management’s assessment.⁶⁰ Additional commenters believed that the management report on internal control should specifically reference the objectives contained in Section 103 of the Sarbanes-Oxley Act.⁶¹ Furthermore, although Section 404(b) of the Sarbanes-Oxley Act does not explicitly direct us to require companies to file the registered public accounting firms’ attestation reports as part of the companies’ annual report filings, we proposed a filing

⁵⁵ Control procedures were described as policies and procedures in addition to the control environment and accounting system that management established to provide reasonable assurance that specific entity objectives will be achieved. SAS 55 also states that control procedures may generally be categorized as procedures that include, among other things, “adequate safeguards over access to and use of assets and records, such as secured facilities and authorization for access to computer programs and data files.” See Statement on Auditing Standards No. 55, paragraph no. 11.

⁵⁶ See COSO “Addendum to Reporting to External Parties,” *Internal Control—Integrated Framework*, (1994) (“1994 Addendum”) at p. 154.

⁵⁷ The COSO Report states: “Although these [objectives relating to safeguarding of resources] are primarily operations objectives, certain aspects of safeguarding can fall under other categories * * * [T]he goal of ensuring that any such asset losses are properly reflected in the entity’s financial statements represents a financial reporting objective.” The category in which an objective falls can sometimes depend on the circumstances. Continuing the discussion of safeguarding of assets, controls to prevent theft of assets—such as maintaining a fence around inventory and a gatekeeper verifying proper authorization of requests for movement of goods—fall under the operations category. These controls normally would not be relevant to the reliability of financial statement preparation, because any inventory losses would be detected pursuant to periodic physical inspection and recorded in the financial statements. However, if for financial reporting purposes management relies solely on perpetual inventory records, as may be the case for interim reporting, the physical security controls would then also fall within the financial reporting category. This is because these physical security controls, along with other controls over the perpetual inventory records, would be needed to ensure reliable financial reporting. *Id.* at 37.

⁵⁸ As stated in n. 1 to the 1994 Addendum, the FCPA requires companies, among other things, 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 * * * to maintain accountability for

⁵⁹ See letters regarding File No. S7–40–02 of: ABA; CSC; EEI; FED; Eastman Kodak Co. (“Kodak”); KPMG; Protiviti; and PwC.

⁶⁰ See letters regarding File No. S7–40–02 of: ACCA and Financial Executives Institute (“FEI”).

⁶¹ See letters regarding File No. S7–40–02 of: AICPA; BDO Seidman, LLP (“BDO”); D&T; Ernst & Young LLP (“E&Y”); KPMG; and PwC.