

requirement that most of those commenting on this aspect of the proposal supported.

### 3. Final Rules

After evaluating the comments received, we are adopting the proposals with several modifications. The final rules require a company's annual report to include an internal control report of management that contains:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company;
- A statement identifying the framework used by management to conduct the required evaluation of the effectiveness of the company's internal control over financial reporting;
- Management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including a statement as to whether or not the company's internal control over financial reporting is effective.<sup>62</sup> The assessment must include disclosure of any "material weaknesses" <sup>63</sup> in the company's internal control over financial reporting identified by management. Management is not permitted to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses in the company's internal control over financial reporting; and
- A statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the registrant's internal control over financial reporting.<sup>64</sup>

As proposed, our final rules also require a company to file, as part of the company's annual report, the attestation

report of the registered public accounting firm that audited the company's financial statements.

#### a. Evaluation of Internal Control Over Financial Reporting

In the Proposing Release, we requested comment on whether we should establish specific evaluative criteria for management's report on internal control. All of the commenters responding to this request supported the establishment of such evaluative criteria in order to improve comparability among the standards used by companies to conduct their annual internal control evaluations.<sup>65</sup> Several commenters believed that we either should adopt the COSO Framework as the means by which management must evaluate its company's internal control over financial reporting or, alternatively, simply acknowledge the COSO Framework as being suitable for purposes of management's evaluation. Other commenters suggested that we require management to evaluate the effectiveness of a company's internal control over financial reporting using suitable control criteria established by a group that follows due process procedures.

After consideration of the comments, we have modified the final requirements to specify that management must base its evaluation of the effectiveness of the company's internal control over financial reporting on 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.<sup>66</sup>

The COSO Framework satisfies our criteria and may be used as an evaluation framework for purposes of management's annual internal control evaluation and disclosure requirements. However, the final rules do not mandate use of a particular framework, such as the COSO Framework, in recognition of the fact that other evaluation standards exist outside of the United States,<sup>67</sup> and that frameworks other than COSO may be developed within the United States in the future, that satisfy the intent of the statute without diminishing the

benefits to investors. The use of standard measures that are publicly available will enhance the quality of the internal control report and will promote comparability of the internal control reports of different companies. The final rules require management's report to identify the evaluation framework used by management to assess the effectiveness of the company's internal control over financial reporting.<sup>68</sup>

Specifically, a suitable framework must: be free from bias; permit reasonably consistent qualitative and quantitative measurements of a company's internal control; be sufficiently complete so that those relevant factors that would alter a conclusion about the effectiveness of a company's internal controls are not omitted; and be relevant to an evaluation of internal control over financial reporting.<sup>69</sup>

#### b. Auditor Independence Issues

Because the auditor is required to attest to management's assessment of internal control over financial reporting, management and the company's independent auditors will need to coordinate their processes of documenting and testing the internal controls over financial reporting. However, we remind companies and their auditors that the Commission's rules on auditor independence prohibit an auditor from providing certain nonaudit services to an audit client.<sup>70</sup> As the Commission stated in its auditor independence release, auditors may assist management in documenting internal controls. When the auditor is engaged to assist management in documenting internal controls, management must be actively involved in the process. We understand the need for coordination between management and the auditor, however, we remind companies and auditors that management cannot delegate its responsibility to assess its internal controls over financial reporting to the auditor.<sup>71</sup> The rules adopted today do

<sup>62</sup> Management must state whether or not the company's internal control over financial reporting is effective. A negative assurance statement indicating that nothing has come to management's attention to suggest that the company's internal control over financial reporting is not effective will not be acceptable.

<sup>63</sup> A "material weakness" is defined in Statement on Auditing Standards No. 60 (codified in Codification of Statements on Auditing Standards AU § 325) as a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by errors or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. See discussion in Section II.B.3.b. below.

<sup>64</sup> See new Item 308 of Regulations S-B and S-K, Item 15 of Form 20-F and General Instruction B(6) of Form 40-F.

<sup>65</sup> Many commenters cited the absence of evaluative criteria in AU § 319 in their arguments against the reference to AU § 319 in our proposed definition of "internal controls and procedures for financial reporting."

<sup>66</sup> See amended Exchange Act Rule 13a-15(c) or 15d-15(c), amended Item 15 of Form 20-F and amended General Instruction (B) to Form 40-F.

<sup>67</sup> The *Guidance on Assessing Control* published by the Canadian Institute of Chartered Accountants and the *Turnbull Report* published by the Institute of Chartered Accountants in England & Wales are examples of other suitable frameworks.

<sup>68</sup> We are aware that some of the evaluation frameworks used to assess a foreign company's internal controls in its home country do not require a statement regarding whether the company's system of internal control has been effective. Under our final rules, management of a foreign reporting company who relies on such an evaluation framework used in its home country is nevertheless under an obligation to state affirmatively whether its company's internal controls are, or are not, effective.

<sup>69</sup> See AT § 101, paragraph 24.

<sup>70</sup> See Release No. 33-8183 (Jan. 28, 2003) [68 FR 6006].

<sup>71</sup> Management's acceptance of responsibility for the documentation and testing performed by the auditor does not satisfy the auditor independence rules.