

not amend the Commission's rules on auditor independence.

c. Material Weaknesses in Internal Control Over Financial Reporting

In the Proposing Release, we did not propose any specific standard on which management would base its conclusion that the company's internal control over financial reporting is effective. We requested comment on whether we should prescribe specific standards upon which an effectiveness determination would be based, and also what standards we should consider. Several commenters agreed that the final rules should specify standards, and all believed that the existence of a material weakness in internal control over financial reporting should preclude a conclusion by management that a registrant's internal control over financial reporting is effective. We have considered these comments, and agree that the rules should set forth this threshold for concluding that a company's internal control over financial reporting is effective.

The final rules therefore preclude management from determining that a company's internal control over financial reporting is effective if it identifies one or more material weaknesses in the company's internal control over financial reporting.⁷² For purposes of the final rules, the term "material weakness" has the same meaning as in the definition under GAAS and attestation standards.⁷³ The final rules also specify that management's report must include disclosure of any "material weakness" in the company's internal control over financial reporting identified by management in the course of its evaluation.⁷⁴

d. Method of Evaluating

Many commenters addressed the method of evaluating internal control over financial reporting, and some sought additional precision or guidance

regarding the extent of evaluation, including the documentation required.⁷⁵ The methods of conducting evaluations of internal control over financial reporting will, and should, vary from company to company. Therefore, the final rules do not specify the method or procedures to be performed in an evaluation. However, in conducting such an evaluation and developing its assessment of the effectiveness of internal control over financial reporting, a company must maintain evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of the company's internal control over financial reporting. Developing and maintaining such evidential matter is an inherent element of effective internal controls.⁷⁶ An instruction to new Item 308 of Regulations S-K and S-B and Forms 20-F and 40-F reminds registrants to maintain such evidential matter.⁷⁷

The assessment of a company's internal control over financial reporting must be based on procedures sufficient both to evaluate its design and to test its operating effectiveness. Controls subject to such assessment include, but are not limited to: controls over initiating, recording, processing and reconciling account balances, classes of transactions and disclosure and related assertions included in the financial statements; controls related to the initiation and processing of non-routine and non-systematic transactions; controls related to the selection and application of appropriate accounting policies; and

controls related to the prevention, identification, and detection of fraud. The nature of a company's testing activities will largely depend on the circumstances of the company and the significance of the control. However, inquiry alone generally will not provide an adequate basis for management's assessment.⁷⁸

An assessment of the effectiveness of internal control over financial reporting must be supported by evidential matter, including documentation, regarding both the design of internal controls and the testing processes. This evidential matter should provide reasonable support for the evaluation of whether the control is designed to prevent or detect material misstatements or omissions; for the conclusion that the tests were appropriately planned and performed; and that the results of the tests were appropriately considered. The public accounting firm that is required to attest to, and report on, management's assessment of the effectiveness of the company's internal control over financial reporting also will require that the company develop and maintain such evidential matter to support management's assessment.⁷⁹

e. Location of Management's Report

Although the final rules do not specify where management's internal control report must appear in the company's annual report, we think it is important for management's report to be in close proximity to the corresponding attestation report issued by the company's registered public accounting firm. We expect that many companies will choose to place the internal control report and attestation report near the companies' MD&A disclosure or in a portion of the document immediately preceding the companies' financial statements.

C. Quarterly Evaluations of Internal Control Over Financial Reporting

1. Proposed Rule

We proposed to require a company's certifying officers to evaluate the effectiveness of the company's internal controls and procedures for financial reporting as of the end of the period covered by each annual and quarterly

⁷² This is consistent with interim attestation standards. See AT § 501.

⁷³ The term "significant deficiency" has the same meaning as the term "reportable condition" as used in AU § 325 and AT § 501. The terms "material weakness" and "significant deficiency" both represent deficiencies in the design or operation of internal control that could adversely affect a company's ability to record, process, summarize and report financial data consistent with the assertions of management in the company's financial statements, with a "material weakness" constituting a greater deficiency than a "significant deficiency." Because of this relationship, it is our judgment that an aggregation of significant deficiencies could constitute a material weakness in a company's internal control over financial reporting.

⁷⁴ See new Item 308(d) of Regulations S-B and S-K.

⁷⁵ See, for example, letters re: File No. S7-40-02 of: ABA; AICPA; BDO; Intel; and Eli Lilly and Company.

⁷⁶ Section 13(b)(2)(A) of the Exchange Act [15 U.S.C. 78m(b)(2)(A)] requires companies to "make and keep books, records, and accounts, which in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer." See also Section 13(b)(2)(B) of the Exchange Act [15 U.S.C. 78m(b)(2)(B)] and *In re Microsoft Corp.*, Administrative Proceeding File No. 3-10789 (June 3, 2002). In the *Microsoft* order, the Commission stated that such books and records include not only general ledgers and accounting entries, but also memoranda and internal corporate reports. We have previously stated, as a matter of policy, that under Section 13(b)(2) "every public company needs to establish and maintain records of sufficient accuracy to meet adequately four interrelated objectives: appropriate reflection of corporate transactions and the disposition of assets; effective administration of other facets of the issuer's internal control system; preparation of its financial statements in accordance with generally accepted accounting principles; and proper auditing." Statement of Policy Regarding the Foreign Corrupt Practices Act of 1977, Release No. 34-17500 (Jan. 29, 1981) [46 FR 11544].

⁷⁷ See Instruction 1 to new Item 308 of Regulations S-K and S-B, Instruction 1 to Item 15 of Form 20-F and Instruction 1 to paragraphs (b), (c), (d) and (e) of General Instruction B.6 to Form 40-F.

⁷⁸ This statement should not be interpreted to mean that management personally must conduct the necessary activities to evaluate the design and test the operating effectiveness of the company's internal control over financial reporting. Activities, including those necessary to provide management with the information on which it bases its assessment, may be conducted by non-management personnel acting under the supervision of management.

⁷⁹ See Statements on Standards for Attestation Engagements No. 10.