

# defining issues<sup>®</sup>

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## ALERT

## SEC Adopts Internal Control Rules—Delays Implementation

On May 27, 2003, the Securities and Exchange Commission voted to adopt final rules and amendments governing management's reporting on internal control over financial reporting and certification of disclosures in Exchange Act periodic reports. These actions implement the requirements of Section 404 of the Sarbanes-Oxley Act of 2002, proposed in October 2002, and the amendments to the officer certifications required by Sections 302 and 906 of the Act proposed in March 2003. This edition of *Defining Issues* is based on observations from the Commission's open meeting and press release. The final rules have not yet been posted to the Commission's Web site.

### IMPLEMENTATION DATES

Issuers, other than foreign private issuers, that meet the definition of an "accelerated filer" in Exchange Act Rule 12b-2, will be required to comply with the requirements for a management report on internal control over financial reporting, including the independent auditors' attestation, for fiscal years ending on or after June 15, 2004 (December 31, 2004, for calendar-year accelerated filers). Accelerated filers are generally U.S. companies that have "public float"<sup>(1)</sup> over \$75 million and have filed an annual report with the Commission.

(1) The aggregate market value of the voting and non-voting common equity held by non-affiliates.

All other issuers, including small-business and foreign-private issuers, will be required to comply with the new rules for their fiscal years ending on or after April 15, 2005 (December 31, 2005, for calendar-year issuers). These dates significantly defer the proposed rule's effective date, "fiscal years ending on or after September 15, 2003."

## MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Issuers, other than registered investment companies, will include in each annual report a management report on internal control over financial reporting that contains these elements:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company;
- A statement identifying the framework (e.g., COSO) used by management to evaluate the effectiveness of internal control over financial reporting (this was not in the proposed rule);
- Management's assessment of the effectiveness of internal control over financial reporting as of the end of the company's most recent fiscal year; and
- A statement that the issuer's independent auditor has issued an attestation report on management's assessment.

Section 404 requires the issuer's independent auditor to report on management's assessment of the effectiveness of the company's internal control over financial reporting in accordance with standards to be established by the Public Company Accounting Oversight Board. The Board intends to make developing these standards one of its priorities.

Under the final rules, management must disclose any material weakness in internal control over financial reporting, and any material weakness will preclude reporting that the company's internal control over financial reporting is operating effectively. The framework on which management's evaluation is based must be 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. The report of the Committee of Sponsoring Organizations of the Treadway Commission (COSO), titled *Internal Control – Integrated Framework*, contains the set of suitable criteria most commonly used in the United States.

The adopting release is expected to remind audit committees and auditors of management's responsibilities for documenting and evaluating internal control over financial reporting and the independence implications of auditors performing management's functions.

## DEFINITION OF INTERNAL CONTROL

According to the press release, in a change from the proposed rules, the final rules will define the term "internal control over financial reporting" this way:

"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, 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:

- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the registrant;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and receipts and expenditures of the registrant are being made only in accordance with authorizations of management and directors of the registrant; and
- 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."

This definition clarifies that, for purposes of reporting pursuant to the provisions of Section 404, internal control over financial reporting encompasses safeguarding of assets.

The final rules will require companies to evaluate quarterly any changes that have materially affected or are reasonably likely to materially affect the company's internal control over financial reporting. This is less demanding than the counterpart in the proposed rule, which called for quarterly evaluations of internal controls over financial reporting by management.



## OFFICERS' CERTIFICATIONS

The final rules also add the certifications required by Sections 302 and 906 of the Act to the list of required exhibits to be included in periodic reports filed with the Commission. The final rules will prescribe the specific form and content of the Section 302 certifications.

The Section 906 certifications will not be subject to liability under Section 18 of the Exchange Act, because the final rules will permit companies to “furnish” rather than “file” the certifications. Nor will the certifications be subject to automatic incorporation by reference into an issuer’s registration statements, and therefore subject to liability under Section 11 of the Securities Act, unless the issuer takes steps to include or incorporate the certifications in a registration statement.

The rules pertaining to Section 302 and Section 906 certifications generally will become effective sixty days after their publication in the Federal Register.

Companies should not treat the descriptive and summary statements in this presentation as a substitute for the actual rules, which are not now available. They should consult the text of the rules and their accounting and legal advisors.

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