INTERNAL CONTROL REPORT 2005

The Board of Directors' Report on Internal Control over Financial Reporting for year 2005

According to the Swedish Companies Act and the Swedish Code of Corporate Governance, the Board of Directors is responsible for ensuring that the Company has satisfactory internal control. This report has been prepared in accordance with the Swedish Code of Corporate Governance, section 3.7.2, and is thereby limited to internal control over financial reporting. This report is not a part of the annual report.

The Swedish Corporate Governance Board has made a pronouncement regarding the Board of Directors' reporting on internal control under the Code of Corporate Governance to the effect that, for 2005, it is not necessary for the Board of Directors to make a statement of how well the internal control over financial reporting has worked, and the Internal Control Report for 2005 does not have to be examined by the auditors. In accordance with this pronouncement, we do not make any such statement in this report for 2005 and this report is not examined by the auditors.

INTERNAL CONTROL OVER THE FINANCIAL REPORTING

Ericsson has integrated risk management and internal control in its business processes. As defined in the COSO framework for internal control, issued by the Committee Of Sponsoring Organizations of the Treadway Commission (COSO), components of internal control are: a control environment, risk assessment, control activities, information and communication, and monitoring.

Control environment

The Company's internal control structure is based on:

- the division of work between the Board of Directors and its committees and the company president
- the Company's organization and mode of operations, with well-defined roles and responsibilities and delegations of authority
- steering documents such as policies and directives, including a code of business ethics and conduct
- a management system based on a number of well-defined planning, operational and support processes.

The most essential parts of the control environment regarding the financial reporting are included in steering documents related to accounting and financial reporting. Such steering documents are updated regularly for changes e.g. in laws, financial reporting standards and listing requirements, such as IFRS and the Sarbanes-Oxley Act (SOX) in the United States.

Risk assessment

Risks related to financial reporting are fraud and loss or embezzlements of assets, undue favorable treatment of counter-parties at the expense of the Company, and other risks of material misstatements in the financial statements, e.g. related to recognition and measurement of assets, liabilities, revenue and cost or insufficient disclosure. Ericsson is managed through common processes, where risk management is integrated in each process, applying various methods for risk assessment and control, to ensure that the risks the Company is exposed to are managed according to established policies. Accounting and reporting policies and directives cover areas of particular significance to support correct accounting, reporting and disclosure.

Control activities

The Company's business processes include financial controls regarding approval and accounting for business transactions. The financial closing and reporting process has controls regarding recognition, measurement and disclosure, including the application of critical accounting policies and estimates, in consolidated companies as well as on group level. All legal entities, business units and market units in Ericsson have their own controller functions participating in planning and evaluation of each unit's performance. Their regular analysis of the financial reports for their respective units, together with analysis performed at group level, is an important element of the internal control to ensure that the financial reports do not contain material errors.

For external financial reporting purposes, additional controls that all disclosure requirements are fulfilled are performed by a Disclosure Committee established by the Company management.

The Company has implemented controls to ensure that the financial reports are prepared in accordance with IFRS. The Company also largely completed implementation of detailed documentation of internal controls related to accounting and financial reporting as well as monitoring of the performance and results of such controls to ensure that Ericsson will be able to assess the effectiveness of the internal control in such a way as to be compliant with SOX requirements. A thorough review of materiality levels related to the financial reports has resulted in implementation of detailed control documentation in a number of subsidiaries with significant scale of operations. For other subsidiaries, overall controls related to their control environment and compliance with policies and directives related to the financial reporting are implemented.

Information and communication

The Company has information and communication channels supporting completeness and correctness of the financial reporting, e.g. by making internal instructions and policies regarding accounting and financial reporting known and accessible to all employees concerned, as well as regular updates and briefing documents regarding changes in accounting policies and reporting and disclosure requirements.

There is regular financial and management reporting by legal and operational units to internal steering groups and Company management, with analysis and comments of financial performance and risks. The Board of Directors receives financial reports monthly. The Audit Committee has established a routine for anonymous reporting by employees any suspected violations of laws, regulations, policies or directives, a so-called "whistleblower" procedure.

Monitoring

The Company's financial performance is reviewed at each Board meeting. The committees of the Board fulfill important monitoring functions regarding remuneration, borrowing, investments, customer financing, cash management, financial reporting and internal control. The Audit Committee and the Board of Directors review all interim and annual financial reports before they are released to the market.

The Company's process for financial reporting is reviewed annually by the Management and forms a base for the evaluation of the internal management system and internal steering documents to ensure that these cover all significant areas related to financial reporting. The compliance with policies and directives is also monitored through annual self-assessments and representation letters from heads and controllers in all consolidated companies as well as from business units and market units. The Company has an internal audit function reporting to the Audit Committee, which performs independent audits.

ASSESSMENT OF THE INTERNAL CONTROL OVER FINANCIAL REPORTING

As the Company is listed in the United States, the requirements in SOX section 404 regarding assessment of the effectiveness of internal controls over financial reporting are applicable as from the fiscal year 2006. The Company is in the process of implementation of detailed controls, documentation and testing procedures according to the COSO framework to ensure compliance with SOX 404 as from 2006.

Stockholm February 24, 2006
Telefonaktiebolaget LM Ericsson (publ)
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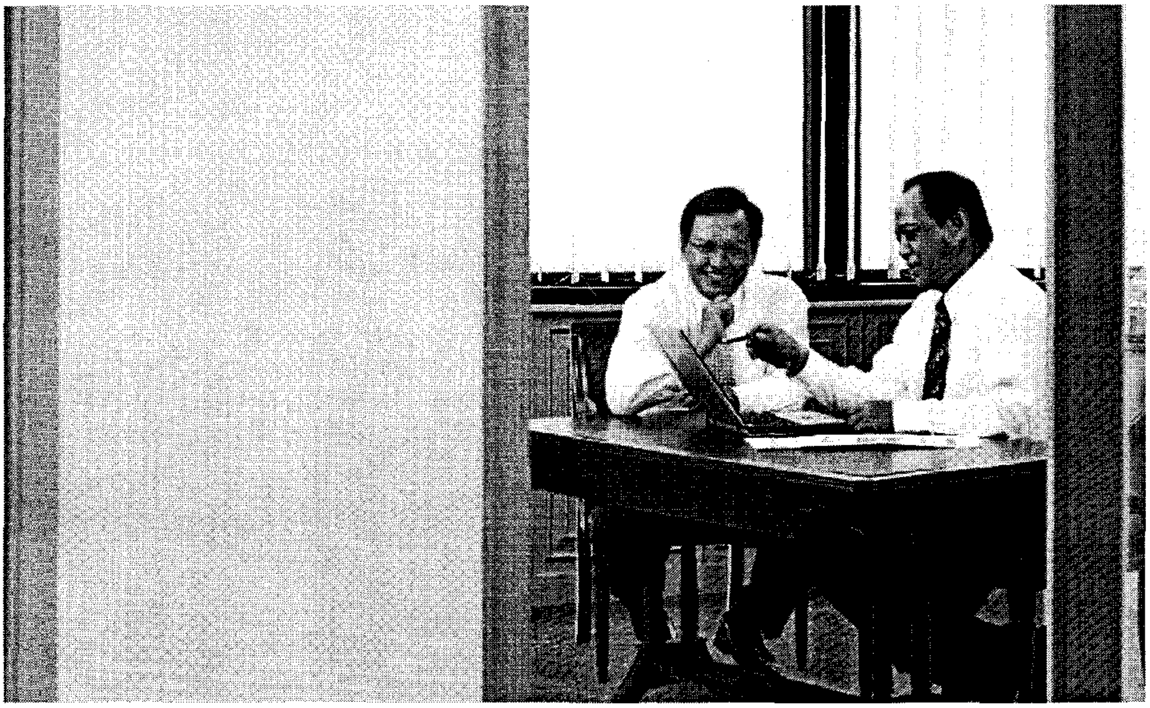
THE BOARD OF DIRECTORS

Laporan Komite Audit



Susunan anggota Komite Audit BCA per 31 Desember 2005 adalah sebagai berikut:

Ketua:	Renaldo Hector Barros
Anggota:	Djoko Sutardjo
	Herman Yoseph Susmanto

Cyrillus Harinowo, Komisaris Independen yang memimpin Komite Audit sampai dengan tanggal 2 Juni 2005, karena rotasi tugas digantikan oleh Renaldo Hector Barros yang juga menjabat sebagai Komisaris Independen.

Tidak ada pergantian lain selama tahun tersebut.

Komite Audit secara konsisten dan terus menerus melanjutkan kerjasama yang erat dengan auditor internal, auditor eksternal, serta berbagai tingkat pejabat eksekutif BCA, untuk memperoleh informasi dan pengetahuan yang memadai tentang kegiatan sepanjang tahun 2005. Laporan ini menyajikan secara ringkas aktivitas Komite Audit sepanjang tahun 2005, yang dikelompokkan dalam beberapa fungsi.

1. **Informasi Keuangan**

   Komite Audit secara seksama memberikan perhatian, melakukan kajian terhadap laporan keuangan tahunan maupun kuartalan, untuk meneliti tingkat kepatuhan BCA terhadap ketentuan legal dan standar pelaporan keuangan yang berlaku sebagaimana diatur dalam Prinsip Standar Akuntansi Keuangan Indonesia, serta prinsip-prinsip pengendalian intern, sehingga meyakini bahwa situasi keuangan dan ekuitas BCA telah mencerminkan tata kelola perusahaan yang baik.

2. **Audit Internal**

   Dalam menjalankan tugasnya, Komite Audit erat bekerja sama dengan Divisi Audit Internal. Pimpinan Divisi Audit Internal selalu memberikan penjelasan secara detail setiap fase pekerjaannya, seperti: a) rencana kerja yang akan diselesaikan dalam satu tahun; b) laporan periodik atas aktivitas audit sepanjang tahun beserta kesimpulan yang diambil; dan c) *monitoring* atas tindak lanjut terhadap rekomendasi dan saran yang disepakati pada setiap laporan audit.

Komite Audit juga meneliti semua laporan audit internal terutama atas temuan-temuan audit di cabang-cabang, wilayah-wilayah, serta unit-unit kerja di kantor pusat selama tahun 2005.

Semua penyimpangan dan temuan yang dipandang signifikan oleh Komite Audit didiskusikan dengan Kepala Divisi Audit Internal beserta pimpinan di divisi tersebut, dan jika dipandang perlu dilaporkan kepada Dewan Komisaris untuk memperoleh tindak lanjut atau tindakan perbaikan.

3. **Audit Eksternal**

   Kantor Akuntan Publik Siddharta Siddharta & Widjaja dari grup KPMG International tetap dipertahankan sebagai auditor eksternal independen yang mengaudit BCA tahun 2005.

   Komite Audit telah dua kali bertemu dengan auditor eksternal dimaksud, untuk memberikan pandangan dan masukan tentang bidang pekerjaan yang perlu diperhatikan secara khusus, berdasarkan telaah audit internal dan pengendalian intern.

   Komite Audit juga telah mengkaji laporan keuangan hasil audit, membahasnya dengan auditor eksternal independen dimaksud, dan menilai bahwa integritas laporan keuangan BCA tahun 2005 memuaskan.

   Komite Audit juga melakukan telaah terhadap laporan keuangan hasil pemeriksaan Bank Indonesia.

4. **Lain-lain**

   Semua *minutes* hasil rapat Dewan Komisaris, Direksi, dan Komite Remunerasi dan Nominasi, yang dilaksanakan tahun 2005 telah dikaji oleh seluruh anggota Komite Audit.

   Perlu juga dilaporkan bahwa anggota Komite Audit BCA secara proaktif berpartisipasi dalam keanggotaan Ikatan Komite Audit Indonesia (IKAI) serta Paguyuban Komisaris Independen Indonesia (PKII). Para anggota saling memberi dan menerima pengalaman-pengalaman tentang cara, pendekatan, identifikasi, dan advokasi, yang akan dapat memperkaya bidang tugas audit independen.

5. **Kesimpulan**

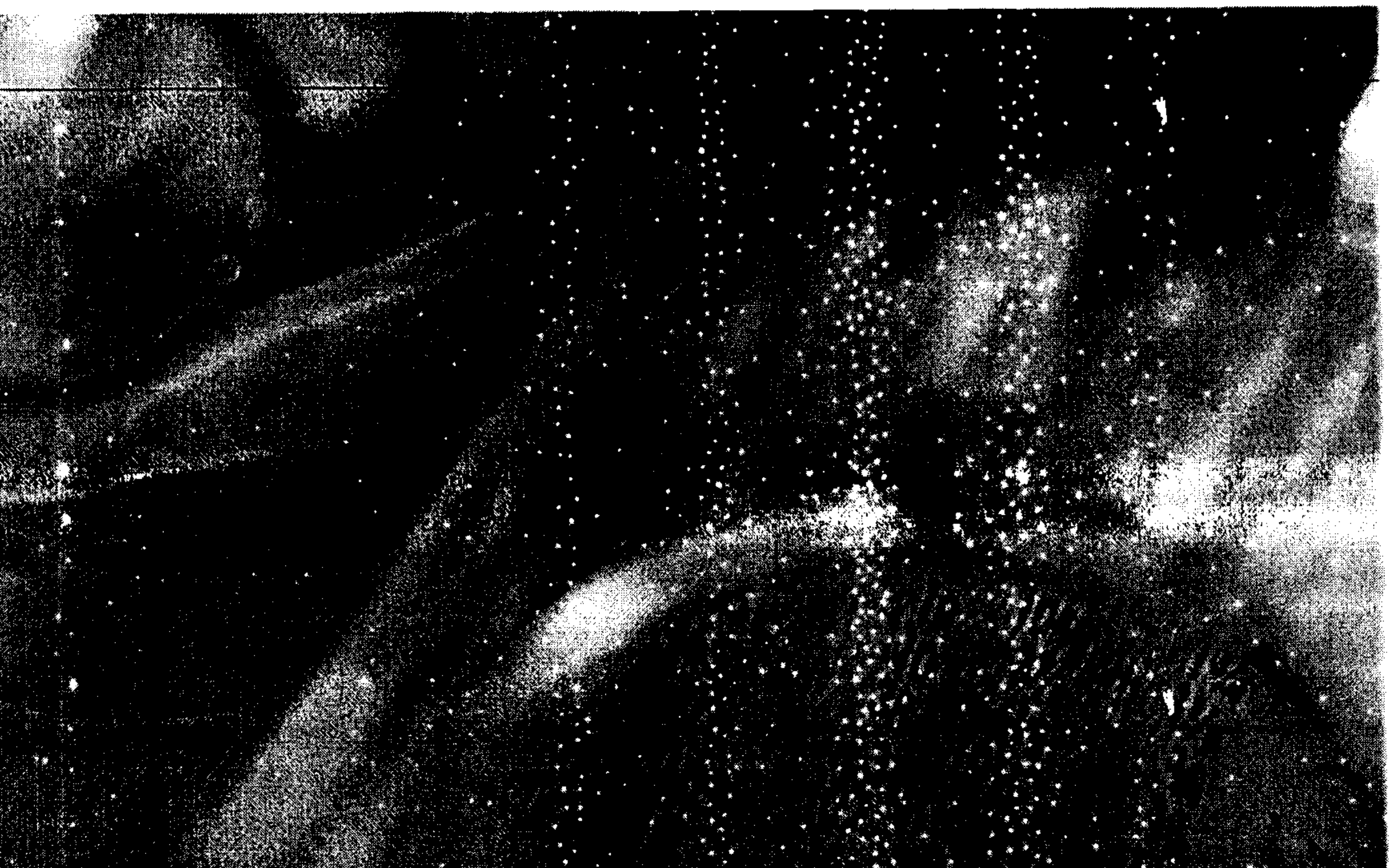
   Dilandasi tugas dan tanggung jawab serta berdasarkan hasil kajian yang dilakukan oleh Komite Audit, seluruh anggota Komite Audit tidak menemukan *issue* yang signifikan untuk dilaporkan. Komite Audit meyakini kualitas, integritas, dan transparansi laporan keuangan reguler, serta efektivitas sistem pengendalian intern PT Bank Central Asia Tbk tahun 2005.

Komite Audit
PT Bank Central Asia Tbk

Renaldo Hector Barros
Ketua

Djoko Sutardjo
Anggota

Herman Yoseph Susmanto
Anggota



ASSESSING AND DOCUMENTING INTERNAL CONTROLS OVER FINANCIAL REPORTING

Steven J. Berkowitz, MBA, CPA

As taxpayers and stakeholders, we entrust federal agency managers with resources worth trillions of dollars and great responsibilities for creating and executing programs on behalf of the American people. Managers implement internal controls to ensure that programs operate effectively and efficiently, financial reporting on these programs is reliable, and agency employees and those acting on behalf of the agency carry out these programs in compliance with all laws and regulations.

In the private sector, financial scandals and poor reporting resulted in billions of dollars in market value dissipating almost overnight. In response to the outcry for reform, Congress passed the Sarbanes-Oxley Act in July 2002, containing specific reporting, certification and audit requirements related to internal controls over financial reporting.

Figure 1

In the public sector, the U.S. Government Accountability Office (GAO) has reiterated that federal agencies do not maintain effective internal controls over financial reporting. In response to this internal control deficiency and to bring Sarbanes-Oxley-like requirements to the federal government, the U.S. Office of Management and Budget (OMB) revised OMB Circular A-123, which requires sweeping changes to many aspects of financial reporting. These new requirements will have significant repercussions in all CFO Act agencies and most likely all other agencies as well.

Consequently, effective in FY 2006, federal agencies must:

- Assess and document their internal controls over financial reporting,
- Document their assessment of the effectiveness and reliability of those internal controls, and
- Provide a separate assurance statement as part of the annual Federal Managers Financial Integrity Act FMFIA) Section 2 assurances asserting whether the internal controls over financial reporting are effective.

This article describes a structured methodology agencies could use to comply with the new assessment and documentation requirements.[1]

THE INTERNAL CONTROL PROCESS

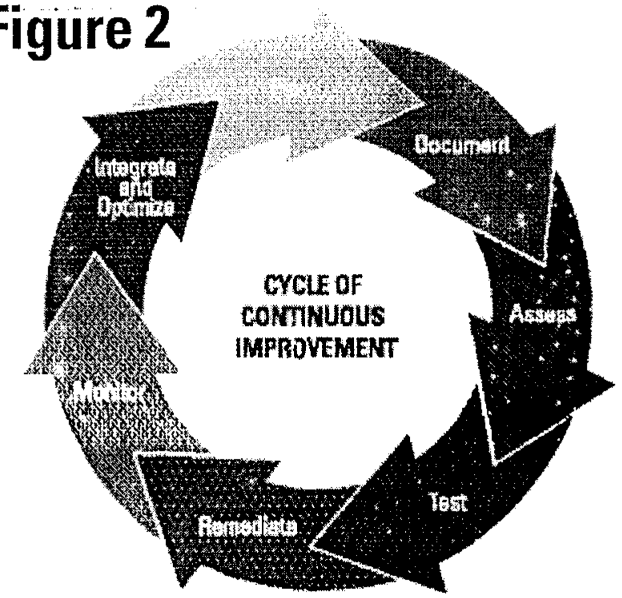
Internal controls over financial reporting provide reasonable assurance that an agency is achieving its financial reporting objectives. *Figure 1* depicts the internal control process.

In sum, an agency first identifies its financial reporting objectives; then identifies events or risks that might prevent the agency from achieving its objectives. Next, the agency will design internal controls to prevent or detect risks, testing those controls and taking remedial action if necessary. Finally, the agency should monitor the operations of the controls on an ongoing basis.

OMB has identified the objectives of internal controls over financial reporting as providing reasonable assurance that management may make the following assertions:

- All transactions that actually occurred during the reporting period are recorded and these transactions comply with all laws and regulations.
- All assets and liabilities that actually existed at the reporting date are recorded.
- All assets, liabilities and transactions that the agency should have reported for the period are reported.
- All assets and liabilities are reported at their proper value.
- All financial information is in the proper form and includes all required disclosures.
- All assets that the agency legally owns and all liabilities that the agency legally owes are recorded.
- All agency assets have been safeguarded against fraud and abuse.
- Documentation for internal controls, all transactions and other significant events is readily available for examination.

Figure 2



1. Plan the approach.
2. Document existing policies and controls over financial reporting.
3. Assess the effectiveness of existing controls.
4. Test the operations of existing controls. Report findings of Phases 1–4.
5. Remediate exceptions as appropriate.
6. Continual monitoring of controls and performance metrics.
7. Integrate and optimize controls into every financial reporting system, process and procedure

Plan

ACTIVITIES
- Education and training
- Establish Project Management Organization (PMO), if appropriate
- Establish Assessment Team
- Determine control template standards and use of enabling technology
- Conduct risk-based scoping exercise: Materiality, accounts, disclosures, known reportable conditions and material weaknesses
- Meet with OIG, if appropriate
- Prepare communications plan
- Develop detailed project plan and obtain approvals
- Establish organizational reporting objectives
- Establish performance metrics for reporting objectives

OUTCOMES
- Control templates
- Communications plan
- Detailed project plan
- Organizational reporting objectives and performance metrics

Document

ACTIVITIES
- Document internal controls over financial reporting in accordance with OMB Circular A-123, Appendix A, Section III and IV
- Accounts or groups of accounts
- Major classifications of transactions
- Process maps, work and data flows
- Review financial statement report disclosures and footnotes
- Review key accounting policies with management and Assessment Team
- Review financial systems architecture
- Identify and document system, process and data interdependencies
- Identify and document risks
- Identify and document deficiencies and opportunities for improvement
- Communicate findings to Assessment Team

OUTCOMES
- Completed control documentation
- Completed work flow, data flow and process diagrams
- Identification of manual versus automated activities
- Draft report on deficiencies and suggestions for improvement

Assess

ACTIVITIES

- Assess the design of internal controls over financial reporting in accordance with OMB Circular A-123, Appendix A, Section III and IV
- Perform gap analysis of controls, architecture and key financial processes
- Assess design risks
- Identify and document deficiencies and opportunities for improvement
- Begin preliminary testing or review of previous results
- Communicate findings to Assessment Team

OUTCOMES

- Completed control documentation
- Gap analysis, including proposed improvement plan
- Draft report on deficiencies and suggestions for improvement

Test

ACTIVITIES

- Develop test plans
- Submit test plans to Assessment Team for approval
- Perform tests, as applicable
- Document results
- Identify and document deficiencies and opportunities for improvement
- Perform review to determine best methods for fully integrating OMB Circular A-123 compliance activities.
- Document improved process for next cycle—"Lessons Learned"
- Identify and document risk responses

OUTCOMES

- Draft and final test plans
- Detailed attestation results
- Final report of deficiencies and suggestions for improvement
- Detailed plan for fully integrating OMB Circular A-123 compliance activities
- Detailed lessons learned
- Risk portfolio and management plan

Remediate

ACTIVITIES

- Rank order improvement opportunities within:
- Controls
- Architecture
- Key Financial Processes
- Select improvement opportunities
- Engage implementation resources
- Prepare remediation project plan (corrective action plan)
- Automate key activities to drive accurate, timely and consistent internal control reporting
- Re-assess affected areas and update documentation
- Provide management with updated documentation

OUTCOMES

- Detail remediation project plan
- Revised OMB Circular A-123 assessment and documentation

Monitor

ACTIVITIES

- Continuous improvement of financial and management controls and processes using appropriate technology enablers
- Monitoring of controls, processes and systems to maximize value and efficiency
- Management of key performance and compliance indicators
- Continuous compliance monitoring and reporting
- Continuous monitoring of objectives and proactive adjustments, when required

OUTCOMES

- Performance reports
- Real-time notification for triggering events, such as noncompliance with established controls, procedures and regulations, improper payments and anti-deficiency
- Real-time actionable information

Integrate and Optimize

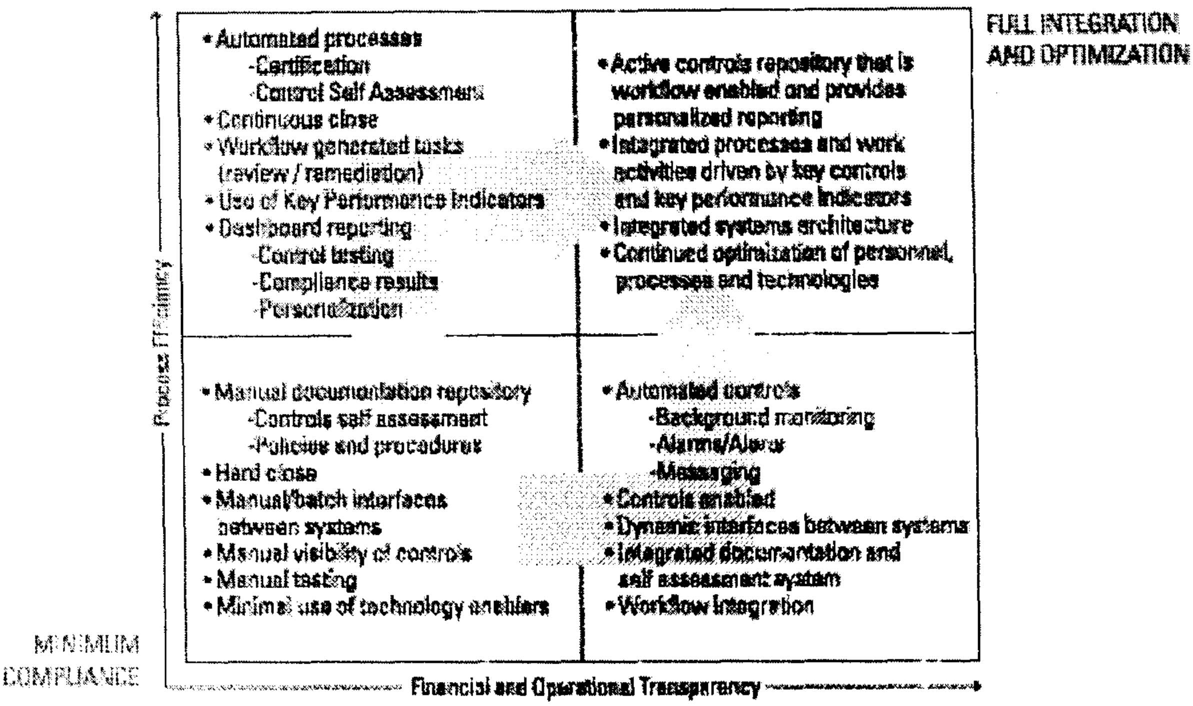
ACTIVITIES

- Implement remediation plan
- Fully integrate controls into each system, process and procedure
- Improve financial reporting controls and processes using appropriate technology enablers.
- Identify and eliminate inefficiencies and redundancies
- Streamline processes and system interoperability

OUTCOMES

- Integrated and optimized internal controls over financial reporting

Figure 3



Moreover, OMB has identified a step-by-step process that agencies should follow to comply with the new requirements. These steps include:

- Establishing a senior assessment team with responsibility over the entire assessment and documentation process.
- Identifying the financial reports that the agency will assess and document. OMB requires that the annual financial statement be included and leaves it up to each agency to identify other significant financial reports.
- Evaluating internal controls at the entity level using the five components of internal controls: control environment; risk assessment; control activities; information and communication; and monitoring.
- Evaluating internal controls at the process, transaction or application level including identifying significant accounts and major classes of transactions and assessing the financial reporting process.
- Testing controls and assessing whether they support management's assertions.
- Ensuring that the agency has documentation for all internal controls, and that it documents the process it followed to assess the reliability of the controls.
- The senior assessment team must document the entire process it followed to conduct the assessment.

The result of this process is a determination as to whether the internal controls provide reasonable assurance over the financial reporting objectives. This entire process must be completed by June 30, 2006, which is the "as of" date for the FMFIA assurance.

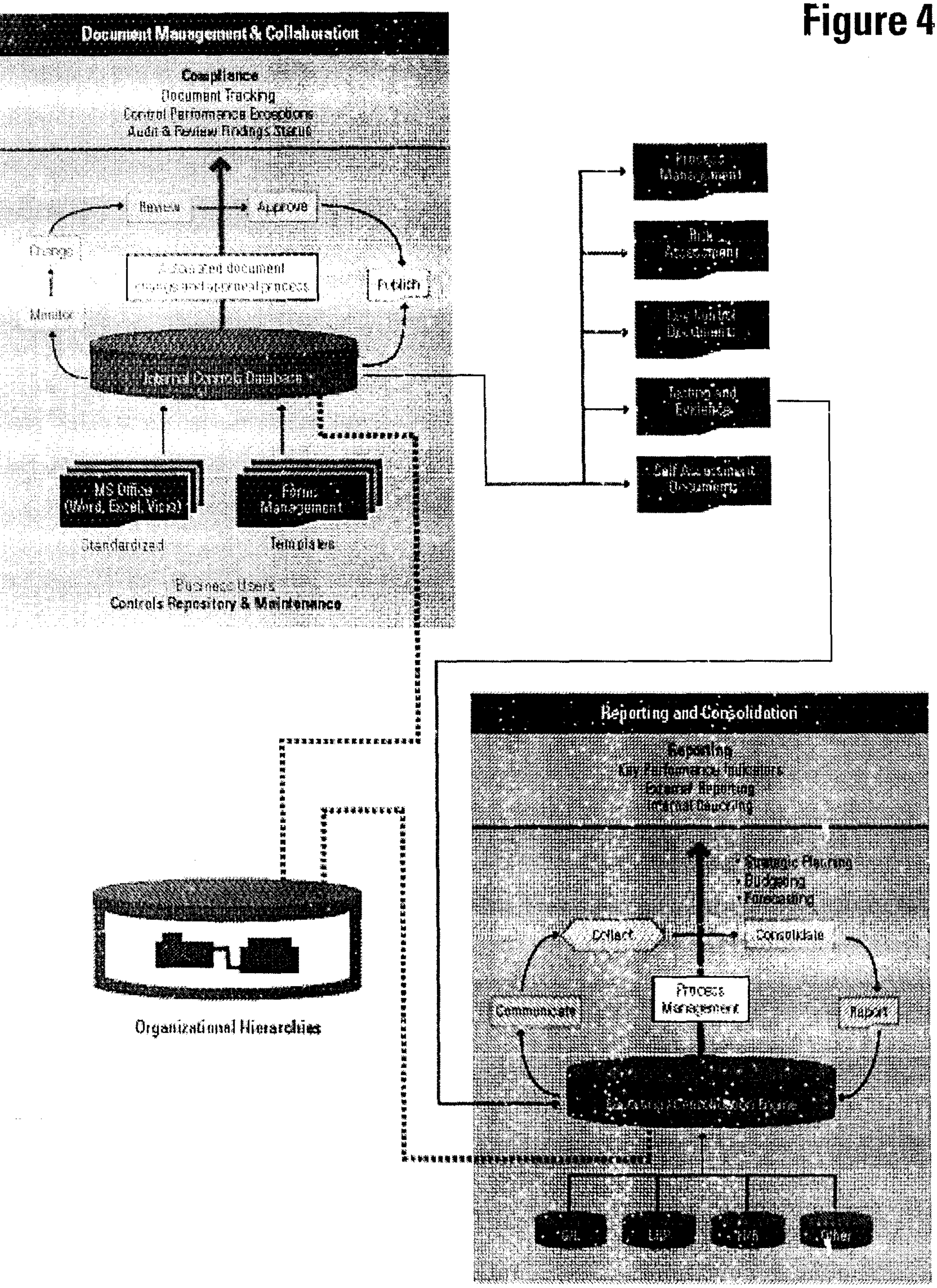
This general description of the revised circular's requirements is only meant to provide context. For a more thorough description of the step-by-step process, please read appendix A of the revised circular.

APPROACH TO COMPLY WITH THE NEW REQUIREMENT

The following is a structured approach agencies could consider to assess and document internal controls over financial reporting.

First, I recommend that agencies conduct a pre-assessment that would include obtaining and reviewing existing documentation that describes the policies and procedures related to internal controls over financial reporting at the major organizations within the agency for major financial statement accounts and significant business processes. For example, one may select financial statement accounts such as fund balance, investments, accounts receivable, inventory, property plant and equipment, entitlement benefits payable, grant liability, appropriations used, nonexchange revenue, transfers in and out, undelivered orders, and intra-governmental assets, liabilities, revenue and expense. The specific accounts selected will vary by agency. For business processes, one could select grants, contracts and payroll.

Figure 4


Document Management & Collaboration
Compliance
Document Tracking
Control Performance Exceptions
Audit & Review Findings Status
Review
Approve
Change
Publish
Monitor
Internal Controls Database
MS Office (Word, Excel, Visio)
Forms Management
Standardized
Templates
Business Users
Controls Repository & Maintenance
Risk Assessment
Testing and Evidence
Self Assessment Documents
Organizational Hierarchies
Reporting and Consolidation
Reporting
Key Performance Indicators
External Reporting
Strategic Planning
Budgeting
Forecasting
Collect
Consolidate
Communicate
Process Management
Report
Other

The purpose of the pre-assessment is not to review and assess the internal controls in detail; instead, the purpose is to see immediately where documentation gaps may exist so remediation can begin as soon as possible.

Once the pre-assessment is complete, then the following phased approach would help agencies complete the entire assessment and documentation process. *Figure* 2 shows the assessment cycle.

For each phase of the assessment, the following are the expected activities and outcomes that one would expect. Following a structured methodology with specific activities and outcomes will allow for rapid completion and high-quality results.

I suggest agencies use the GAO Financial Audit Manual (FAM) as the guide for conducting the actual testing of controls. The GAO FAM is used by auditors as a guide for conducting the annual CFO Act audits, and it includes all of the control templates and guidelines necessary for management to ensure the reliability of its own assessment of the effectiveness of internal controls.

OPTIMIZATION OF INTERNAL CONTROLS OVER FINANCIAL REPORTING

OMB has suggested that agencies consider creating a fully integrated internal control over financial reporting process by taking advantage of state-of-the-art technologies that may result in both efficiencies and transparency over financial reporting. *Figure* 3 shows quadrants from minimum compliance to integrated and optimized compliance and the features exhibited in each quadrant.

An integrated internal controls system may include the features contained in *Figure* 4. This approach takes advantage of modern systems technology, document management technology and dashboard capabilities. An integrated system would help provide one version of the truth, serve as a single source repository for all internal control documentation, and will result in substantial administrative savings.

A key feature of an integrated internal control framework is that all documentation of internal controls, the assessment of internal controls and all processes are housed in one database for ease of use, consistency and validation. This structure would provide a repository for key content, content creation and management for standard operating procedures, codes of conduct, controls, human resource policies and so forth. Moreover, the structure provides for a collaborative workplace to provide visibility to business processes and roll-ups to manage internal controls proactively, to provide automated routing and approval of key content based on defined business rules that support management and audit requirements. Importantly, an integrated structure would allow for archival and easy access to information for reporting, audit and compliance dashboard reporting.

CONCLUSION

The revised OMB Circular A-123 will require significant changes by agency executives, financial managers and others. For the first time, agencies are required to document their internal controls over financial reporting, to assess annually whether the internal controls over financial reporting are effective at meeting financial reporting objectives, and the agency heads must assert under the FMFIA whether the internal controls over financial reporting are effective at meeting the objectives of reliable financial reporting. We know that what gets measured gets attention, so we may expect agency executives to focus on this extensively over the next year. A well-defined, structured, step-by-step approach to address the new requirements will result in a rapid completion of the required assessment and documentation. Agencies may consider an integrated internal controls framework to foster efficiencies in creating, managing and reporting on the internal controls over financial reporting. ■

End Note

1. For a detailed review of internal controls, read OMB Circular A-123 (*www.whitehouse.gov/omb/circulars/a123/a123_rev.pdf*), the GAO *Standards for Internal Control in the Federal Government* (GAO/AIMD-00-21.3.1) and the GAO *Internal Control Management and Evaluation Tool* (GAO-01-1008G).

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AUDITING

Proposed revisions to SSARS no. 1 make some bold changes.

A New Approach to COMPILATIONS

BY DIANE S. CONANT AND J. RUSSELL MADRAY

EXECUTIVE SUMMARY

- **THE AICPA ACCOUNTING AND REVIEW SERVICES** committee issued a proposed revision of SSARS no. 1, *Compilation and Review of Financial Statements,* in December 1999. It gives accountants new communications alternatives they can use when compiled financial statements will be restricted to management use only.
- **THE PROPOSAL DOES NOT PROVIDE AN EXEMPTION** from SSARS no. 1 or create another level of service. An accountant would still have to compile the financial statements restricted to management's use under existing SSARS no. 1 performance standards.
- **A NEW DEFINITION OF "SUBMISSION OF FINANCIAL** statements" would exclude the modification concept and instead focus only on the generation of financial statements. The new communication options the revision provides would be appropriate only when the accountant does not expect third parties to use the financial statements.
- **ACCOUNTANTS WOULD HAVE TWO NEW COMMUNICATION** options available to them: an engagement letter agreed to and signed by management or a letter addressed directly to management. These letters would include much of the same information currently contained in the standard compilation report.
- **THE ED DEFINES THIRD PARTIES AS ALL PARTIES** except members of management who are knowledgeable about the nature of the procedures applied and the basis of accounting or assumptions used in presenting the financial statements. This means some members of management—those not knowledgeable about the entity's accounting matters—could be considered third parties.

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After years of attempts to alter the requirements or exempt certain services, the AICPA accounting and review services committee (ARSC) has issued an exposure draft that seeks to make fundamental changes in compilation engagements. The December 31, 1999, ED would revise Statement on Standards for Accounting and Review Services (SSARS) no. 1, *Compilation and Review of Financial Statements,* which established performance and reporting standards for compilation and review engagements. Previous auditing standards required accountants to add a disclaimer to the unaudited financial statements they were associated with. Exhibit 1 provides an overview of the changes the new ED proposes.

WHY FIX IT?

SSARS no. 1 was supposed to establish a minimum level of service for unaudited financial statements of nonpublic entities. To accomplish this, there is a trigger in paragraph 7 that says that, "The accountant should not *submit* unaudited financial statements of a nonpublic entity to his or her client or others unless, as a minimum, he or she complies with the provisions of this statement applicable to a compilation engagement. Submission of financial statements is defined as presenting to a client or others financial statements that the accountant has (a) *generated,* either manually or through the use of computer software, or (b) *modified,* by materially changing account classification, amounts, or disclosures directly on client-prepared financial statements." (Italics have been added for emphasis.) This means that if the accountant generates a financial statement or modifies a client-generated financial statement, he or she has "submitted" a financial statement, triggering the need to comply with the performance and reporting standards in SSARS no. 1.

Although this trigger effectively established a minimum level of service, in the years since SSARS no. 1 was issued, the accounting profession, the competitive environment and technology have all changed. These progressive changes have led to problems for practitioners, including deciding whether or not SSARS applies (see case study 1). Many times an accountant is forced either to compile financial statements or violate the SSARS professional standards.

Case Study 1

To Apply SSARS or Not, That Is the Question

A client asks for help finding a problem in an income statement that he or she has just printed—net income just doesn't "look right." You sit down and begin to review the prior month's entries in the client's computerized accounting database and notice that four checks totaling $15,000—a material amount—were coded incorrectly as "repairs and maintenance." Based on your close association with the client and your knowledge of the prior month's activities, you know the checks should have been coded as "leasehold improvements." To solve the problem you simply change the account classifications and log out of the software.

Did you just "submit" financial statements? In our opinion, you did, because you *materially modified* the client's financial statement by changing account classifications (paragraph 7 of SSARS no. 1). Did you intend to compile the financial statements? Probably not. Must you now *compile* the client's financial statements? According to SSARS no. 1, you must.

What if, instead of going to the client's office, you made the same modifications on a disk in your office or by modem? In our opinion, the answer would be the same; you submitted financial statements and now you must compile those statements.

The other problem accountants face derives from market influences. As client relationships change, many practitioners feel constrained by the requirements of SSARS no. 1. There are instances when a client needs financial statements solely for management purposes. Yet SSARS no. 1 requires accountants to perform a compilation engagement and issue a report on the financial statements even if neither the client nor the accountant believes it is necessary.

A NEW APPROACH

Most of the ideas proposed during the past 22 years involved an exemption from SSARS no. 1, including exemptions for management-use-only financial statements, interim financial statements and computer-generated financial statements. Each of these ideas met opposition from most of the accounting profession. In the new ED, ARSC has taken a different approach: Rather than create an exemption from SSARS no. 1, the committee rewrote the statement to recognize the realities of the accounting profession today.

SSARS no. 1 has always contained performance and reporting standards for compilation engagements. The ED does not change the performance standards. The accountant must still

- Have or obtain a general understanding of the accounting principles and practices of the industry in which the client operates.
- Have or obtain a general understanding of the client's business.
- Obtain more information if the data the client supplies appear to be incorrect, incomplete or otherwise unsatisfactory to compile the financial statements.

- Read the compiled financial statements and consider whether they are appropriate in form and free of obvious material error.

The reporting standards also have not changed. They provide rules for

- The form of a standard compilation report.
- Reporting on financial statements that omit substantially all disclosures.
- Reporting when the accountant is not independent.
- Reporting when there are departures from GAAP or an other comprehensive basis of accounting (OCBOA).

The ED does make two modifications that

- Change the definition of "submission of financial statements."
- Add communication options in certain circumstances.

ARSC decided that although the trigger could be confusing, it still served the valuable purpose of ensuring a minimum level of service on financial statements the accountant *generated* and *presented* to the client and should remain. However, the committee thought modifying the definition of *submission* would solve most applicability problems. It now defines submission of financial statements as "presenting to a client or third parties financial statements that the accountant has generated either manually or through the use of computer software." Although the revised definition may create a loophole for accountants who want to avoid doing a compilation, ARSC decided the change was the best way to address today's technological environment and still retain the trigger.

The second change involves communication options. The compilation report has long been the vehicle an accountant uses to express his or her degree of responsibility for the financial statements to the statement user. ARSC thought there should be other ways of communicating the same information under limited circumstances—for example, an engagement in which the client and accountant do not expect third parties to use the financial statements.

In such an engagement, the accountant could compile the financial statements and have three different ways to explain the accountant's role in the engagement:

- The standard compilation report.
- An engagement letter signed by management.
- A letter addressed directly to management.

The two new options—the two letters—would contain much the same information as a standard compilation report but would simply be in a different format (see the sample engagement letter in exhibit 2). To learn how accountants might use these options in practice, see case study 2.

Case Study 2

There Is No Longer a Question

Assume the same scenario as in case study 1, except you are now practicing under the new SSARS no. 1 and have a signed engagement letter with the client. Each month you go to the client's office and make certain "corrections and adjustments" similar to those in case study 1 to produce financial statements for management's use only. (Per your understanding with the client, the client will not make these financial statements available to third parties.)

Since you are complying with the performance standards (understanding the client's industry, understanding the client's business, taking certain actions if the information appears to be incorrect and reading the compiled financial statements) and you have already communicated with the client via an engagement letter, you are in full conformity with professional standards and are providing exactly what the client has requested in an effective and efficient manner.

You are no longer required to attach a compilation report to the financial statements, although that option is still available. You have instead communicated much of the same information in the engagement letter. Had you attached a compilation report, you would have had to identify all known departures—measurement and disclosure—from GAAP or OCBOA. Through the engagement letter you have indicated that material departures may exist without having to specifically identify them. Because the financial statements are intended for use only by those who can put the information in the proper context (nonthird parties) specific identification is not necessary.

NOT NEW, BUT DIFFERENT

The ED does not create a new type of engagement. According to SSARS no. 1, compilation of financial statements is defined as "presenting in the form of financial statements information that is the representation of management (owners) without undertaking to express any assurance on the statements." ARSC did not change this definition—the financial statements are compiled in accordance with the performance standards whether they are accompanied by the standard report or by one of the new atlernatives described above.

The ED defines third parties as "all parties except for members of management who are knowledgeable about the nature of the procedures applied and the basis of accounting or assumptions used in the presentation of the financial statements." Note that this is a definition by exception—it starts by assuming that *third parties* includes everyone, except certain members of management. Under this definition, some members of management could be considered third parties (those who are not knowledgeable about the entity's accounting matters).

Some who read this proposal will say that all such financial statements will end up in the hands of third parties. While this could happen, ARSC thought this was an issue between the practitioner and his or her client. If the client represents to the accountant that he or she will not make the financial statements available to third parties yet does just that, the practitioner has a larger problem to deal with than complying with SSARS. ARSC recommends that accountants exercise some caution in selecting and retaining clients and recognize that restricted-use compilation engagements may not be appropriate for all clients.

Exposure Draft on Business Valuations

ARSC also issued another exposure draft on December 31, 1999, *Financial Statements Included in Written Business Valuations.* Financial statements an accountant includes in written business valuations frequently contain departures from GAAP or an other comprehensive basis of accounting (OCBOA) because the purpose of such financial statements is solely to help develop and present the value of an entity. ARSC issued this ED to exempt financial statements included in written business valuations from SSARS no. 1 because users of these statements do not require the statements to conform with GAAP or an OCBOA.

The proposed statement

- Exempts from SSARS no. 1 historical financial statements and "normalized" financial statements included in a written business valuation.
- Defines *normalized financial statements* as historical financial statements that have been adjusted to make the financial information meaningful so an accountant can present and compare the financial results of one entity with those of a comparable entity as part of a business valuation engagement.

The proposal was modeled after SSARS no. 6, *Reporting on Personal Financial Statements Included in Written Personal Financial Plans,* which exempts personal financial statements from SSARS no. 1 if the client or accountant does not use the statements to obtain credit or for any purpose other than preparing a written personal financial plan.

A copy of the ED is available on the AICPA Web site (www.aicpa.org). Comments on any aspect of the ED are encouraged and can be sent to Sherry Boothe, Audit and Attest Standards, File 2000, AICPA, 1211 Avenue of the Americas, New York, New York 10036-8775 or e-mailed to Sboothe@aicpa.org. The deadline for comments is June 9, 2000. The statement would be effective upon issuance.

PROVIDING QUALITY SERVICE

There have been several attempts to bring SSARS into conformity with today's accounting profession. Exhibit 3 compares the current ED to one ARSC issued in 1995 to address the problem. Although the 1999 proposal makes changes in SSARS no. 1, it retains the best of what has always existed. SSARS no. 1 still embodies the traditional compilation, but ARSC believes that the proposed changes align the standard with the CPA Vision and equip practitioners to serve their clients well into the twenty-first century. An accountant now will be able to use his or her professional judgment about how to communicate with the client and provide quality service accordingly.

A copy of the ED is available on the AICPA Web site (www.aicpa.org). Comments on any aspect of the ED are encouraged and can be sent to Sherry Boothe, Audit and Attest Standards, File 2000, AICPA, 1211 Avenue of the Americas, New York, New York 10036-8775 or e-mailed to Sboothe@aicpa.org. The deadline for comments is June 9, 2000. The proposed effective date of the revision is for financial statements submitted on or after September 30, 2000.

Plain Paper Revisited

For more than two decades the accounting profession has debated whether to allow CPAs to prepare so-called plain-paper financial statements for management-only use. The term "plain paper" meant CPAs would not have to put their name on bare-bones statements that were intended only for internal use.

To allow CPAs to issue plain-paper financial statements would have required major revisions to SSARS no. 1, *Compilation and Review of Financial Statements*. The AICPA issued SSARS no. 1 in 1978 at a time when the profession was concerned about shielding members from legal action. The statement set compilation as the lowest level of service for financial statements in the belief that there was no way CPAs could be certain their clients would not show internal-use-only financial statements to third parties.

In September 1995 the plain-paper debate led to the exposure draft *Assembly of Financial Statements for Internal Use Only*. It provided an exemption from SSARS no. 1 for internal-use-only financial statements and would have created a fourth level of service—assembly—in addition to audit, review and compilation. In issuing the ED, the AICPA accounting and review services committee (ARSC) acknowledged that SSARS no. 1 made it difficult for CPAs to provide nonpublic clients with needed services in a timely, cost-effective manner. ARSC said many such clients do not need financial statements that comply in all material respects with GAAP—or an other comprehensive basis of accounting—to manage their businesses.

In August 1997 the profession was still holding public hearings to debate whether SSARS no. 1 should be revised to exempt CPAs from having to compile financial statements in certain situations and instead permit them to issue plain-paper financial statements. Plain-paper supporters argued that requiring a compilation ignored client needs at a time of rapid technological advancement. Many clients did not want to pay for a compilation when management-only financial statements could do the job. In addition, many practitioners were already violating the spirit, if not the letter, of SSARS no. 1 by putting together computer-generated financial statements and having the clients push the buttons that printed them. Others argued that changes were not necessary because CPAs already had—but did not understand—the options under existing standards that would allow them to provide clients with timely and cost-effective compilation services.

The 1995 ED never reached final form. In issuing its latest ED in December 1999 to amend SSARS no. 1, ARSC acknowledged the last five years have brought changes to the services clients ask CPAs to perform. Low-cost software means even the smallest entity can prepare its own financial statements. Despite this, many nonpublic companies ask their CPAs to prepare management-only financial statements. The 1999 ED adds communication options to SSARS no. 1 to enable CPAs to use their professional judgment in responding to client needs.

—Peter D. Fleming

go back

SISTEM AKUNTANSI

MULYADI
UNIVERSITAS GADJAH MADA

Penerbit
Salemba Empat

Sistem Akuntansi

Edisi ke-3
Cetakan pertama, Maret 1993
Cetakan kedua, Maret 1997
Cetakan ketiga, Agustus 2001

Penerbit Salemba Empat (PT Salemba Emban Patria)
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Desain *cover* oleh: Risa Rimendi M.

Sistem Akuntansi
Mulyadi

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1 jil.: xxxiv, 646 hlm.; 26 cm

Bibliografi

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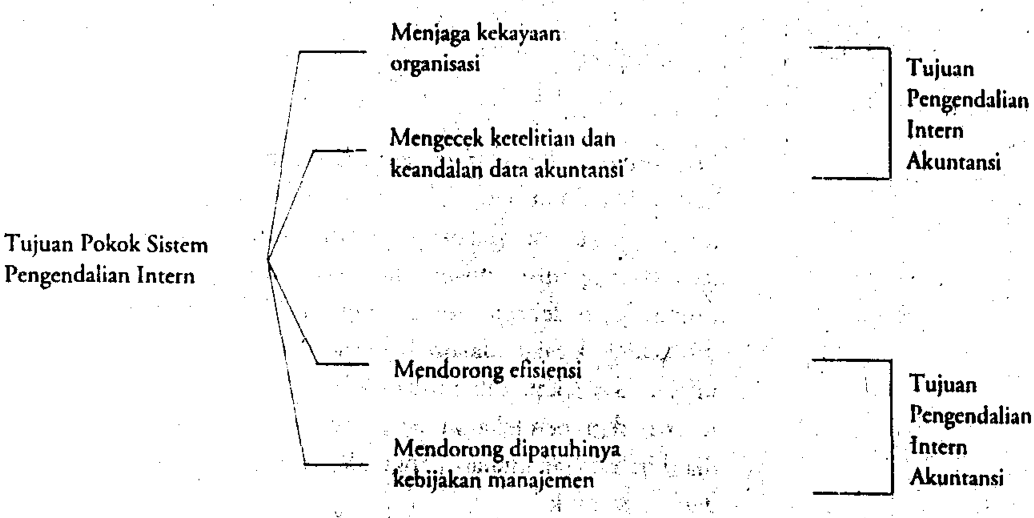
1. Akuntansi I. Judul

intern administratif *(internal administrative control)*. Pengendalian intern akuntansi, yang merupakan bagian dari sistem pengendalian intern, meliputi struktur organisasi, metode dan ukuran-ukuran yang dikoordinasikan terutama untuk menjaga kekayaan organisasi dan mengecek ketelitian dan keandalan data akuntansi. Pengendalian intern akuntansi yang baik akan menjamin keamanan kekayaan para investor dan kreditur yang ditanamkan dalam perusahaan dan akan menghasilkan laporan keuangan yang dapat dipercaya. Pengendalian intern administratif meliputi struktur organisasi, metode dan ukuran-ukuran yang dikoordinasikan terutama untuk mendorong efisiensi dan dipatuhinya kebijakan manajemen. Gambar 6.1 berikut ini menyajikan tujuan sistem pengendalian intern dan pembagian sistem tersebut menurut tujuannya.



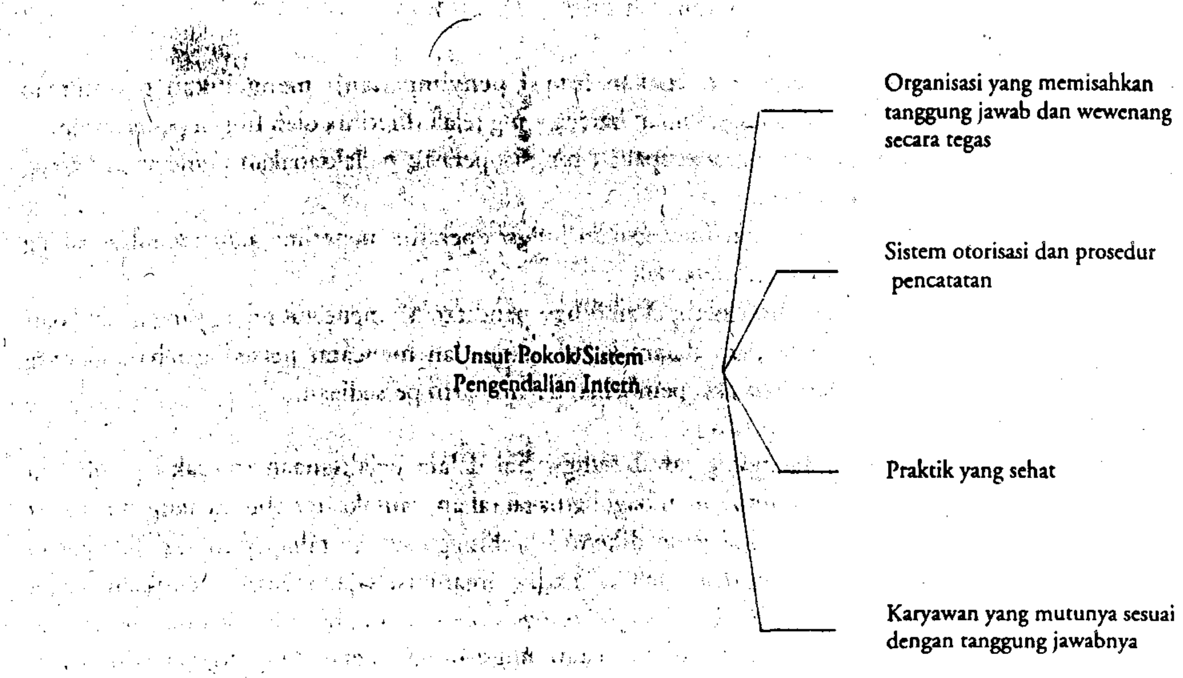
Gambar 6.1 Tujuan Pokok Sistem Pengendalian Intern

ISUR SISTEM PENGENDALIAN INTERN

Unsur pokok sistem pengendalian intern adalah:

1. Struktur organisasi yang memisahkan tanggung jawab fungsional secara tegas.
2. Sistem wewenang dan prosedur pencatatan yang memberikan perlindungan yang cukup terhadap kekayaan, utang, pendapatan dan biaya.
3. Praktik yang sehat dalam melaksanakan tugas dan fungsi setiap unit organisasi.
4. Karyawan yang mutunya sesuai dengan tanggung jawabnya.

Unsur pokok sistem pengendalian intern tersebut disajikan pada Gambar 6.2. Berikut ini diuraikan secara rinci setiap unsur pokok sistem pengendalian intern tersebut.



Gambar 6.2 Unsur Pokok Sistem Pengendalian Intern

Struktur Organisasi yang Memisahkan Tanggung Jawab Fungsional secara Tegas. Struktur organisasi merupakan rerangka *(framework)* pembagian tanggung jawab fungsional kepada unit-unit organisasi yang dibentuk untuk melaksanakan kegiatan-kegiatan pokok perusahaan. Dalam perusahaan manufaktur misalnya, kegiatan pokoknya adalah memproduksi dan menjual produk. Untuk melaksanakan kegiatan pokok tersebut dibentuk departemen produksi, departemen pemasaran, dan departemen keuangan dan umum. Departemen-departemen ini kemudian dibagi-bagi lebih lanjut menjadi unit-unit organisasi yang lebih kecil untuk melaksanakan kegiatan-kegiatan perusahaan. Pembagian tanggung jawab fungsional dalam organisasi ini didasarkan pada prinsip-prinsip berikut ini:

a. Harus dipisahkan fungsi-fungsi operasi dan penyimpanan dari fungsi akuntansi. Fungsi operasi adalah fungsi yang memiliki wewenang untuk melaksanakan suatu kegiatan (misalnya pembelian). Setiap kegiatan dalam perusahaan memerlukan otorisasi dari manajer fungsi yang memiliki wewenang untuk melaksanakan kegiatan tersebut. Fungsi penyimpanan adalah fungsi yang memiliki wewenang untuk menyimpan aktiva perusahaan. Fungsi akuntansi adalah fungsi yang memiliki wewenang untuk mencatat peristiwa keuangan perusahaan.
b. Suatu fungsi tidak boleh diberi tanggung jawab penuh untuk melaksanakan semua tahap suatu transaksi.

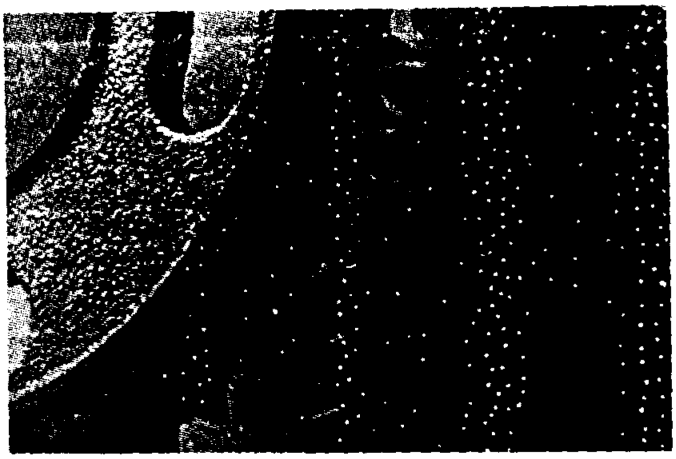
Untuk melaksanakan transaksi pembelian dalam perusahaan misalnya, fungsi-fungsi yang dibentuk adalah: fungsi gudang, fungsi pembelian, fungsi penerimaan, dan fungsi akuntansi, dengan fungsinya masing-masing sebagai berikut:

Sistem Pengendalian Intern dan Penerapannya dalam Perusahaan

Dalam arti sempit, sistem pengendalian intern serupa dengan pengertian internal check yang merupakan prosedur-prosedur mekanis untuk memeriksa ketelitian data-data administrasi seperti mencocokkan penjumlahan secara horisontal maupun vertikal.

Dalam arti luas, Sistem Pengendalian Intern dapat dipandang sebagai sistem sosial yang mempunyai wawasan/makna khusus yang berada dalam organisasi perusahaan yang meliputi: kebijakan, teknik, prosedur, alat-alat fisik, dokumentasi orang-orang dengan berinteraksi satu sama lain dengan diarahkan untuk: (a) melindungi harta; (b) menjamin terhadap "terjadinya utang yang tidak layak" (c) menjamin ketelitian dan dapat dipercayainya data akuntansi; (d) dapat diperolehnya operasi secara efisien dari (e) menjamin ditaatinya kebijakan perusahaan.

AICPA *(American Institute of Certified Public Accountants)* memberi definisi atas Sistem Pengendalian Intern; "Sistem Pengendalian Intern meliputi struktur organisasi, semua metode dan ketentuan-ketentuan yang terkoordinasi yang dianut dalam perusahaan untuk melindungi harta kekayaan, memeriksa ketelitian dan seberapa jauh data akuntansi dapat dipercaya, meningkatkan efisiensi usaha dan mendorong ditaatinya kebijaksanaan perusahaan yang ditetapkan".



...engendalian Intern

Terdapat beberapa tujuan diselenggarakannya Sistem Pengendalian Intern dalam suatu perusahaan, yaitu:

Menjaga kekayaan perusahaan

Dengan adanya sistem otorisasi dalam perusahaan maka aliran kekayaan perusahaan hanya akan terjadi dibawah kendali pemegang wewenang. Juga dengan praktik sehat dalam perusahaan maka akan meminimalisir terjadinya penyimpangan kekayaan perusahaan termasuk mengurangi kemungkinan perbedaan pencatatan dengan keadaan sebenarnya. Sistem yang baik akan memberikan perlindungan yang cukup terhadap kekayaan perusahaan, dan perlindungan terhadap kekayaan perusahaan sangat mempengaruhi jalannya perusahaan dan menentukan hidup matinya perusahaan.

Proses untuk memperoleh karyawan yang *capable* tidak cukup berhenti pada tahap seleksi penerimaan karyawan, setelah menjadi karyawan pun tetap diperlukan pelatihan berkelanjutan bagi karyawan seperti *in house trainning* untuk dapat terus mempertajam kemampuan karyawan. *Capability* karyawan yang memadai memudahkan seluruh kegiatan perusahaan dapat dijalankan sesuai dengan "skenario" dan meminimalisir terjadinya penyimpangan atas "skenario" tersebut.

Mengecek ketelitian data dan keandalan data akuntansi

Sistem Pengendalian Intern yang baik diharapkan dapat memberikan keyakinan bahwa pengolahan data dilakukan dengan tepat, sehingga penggunaannya sebagai dasar dalam penyusunan informasi keuangan dapat menghasilkan laporan keuangan yang teliti dan dapat diandalkan. Laporan Keuangan yang teliti dan dapat diandalkan akan mencerminkan kinerja perusahaan sesungguhnya.

Mendorong Efesiensi

Dalam sistem yang baik, prosedur kerja dilakukan berdasar standar yang telah ditetapkan. Standar kerja tersebut tentunya telah dianalisa sehingga standar yang ditetapkan memiliki berbagai keunggulan misalnya proses kerja yang memerlukan waktu paling cepat, bahan paling sedikit dan prosedur yang sederhana tapi tetap menghasilkan produk yang berkualitas. Dengan sistem pengendalian intern yang baik maka efisiensi dalam perusahaan dapat dengan mudah dicapai, baik efisiensi material, efisiensi waktu maupun efisiensi prosedur. Apabila perusahaan berhasil mencapai tingkat efisiensi yang tinggi, maka beban yang terjadi dalam perusahaan akan makin kecil baik beban material, upah tenaga kerja maupun biaya lainnya termasuk penghematan waktu yang mengakibatkan tingkat produktivitas makin tinggi. Hal ini akan mengakibatkan laba perusahaan, kinerja perusahaan baik kinerja keuangan maupun kinerja operasional meningkat.

Mendorong dipatuhinya kebijaksanaan manajemen

Perusahaan yang memiliki Sistem Pengendalian Intern yang baik maka akan lebih mudah dalam mencapai tujuan

ıan. Dalam sistem yang baik
tentukan dengan jelas tentang
ın apa, siapa yang melakukan
ın kepada siapa bertanggung-
Oleh karena itu segala kebijak-
nanajemen – terlepas dari segala
ıan kebijaksanaan yang ditetap-
kan dipatuhi oleh semua pihak.
baik sistem pengendalian suatu
aaı makin kecil pula penyim-
atas kebijakan manajemen
aan demikian pula sebaliknya.
demikian bila sistem pengen-
intern perusahaan sudah baik
eminimalisir terjadinya krtidak-
pekerja kebijaksanaan yang
oleh manajer.

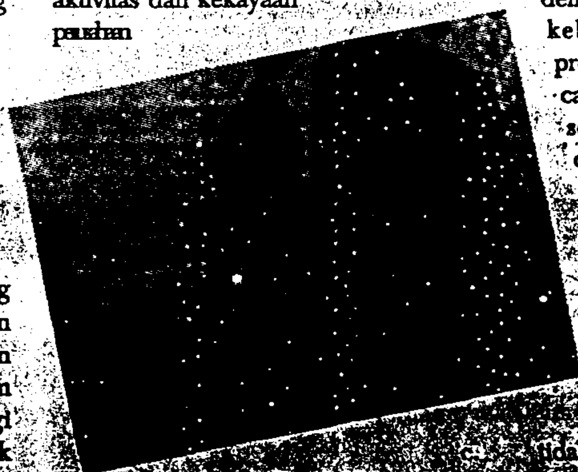
n Pokok
Pengendalian Intern

ngkup pembicaraan Sistem
dalian Intern tidak dapat dile-
dari unsur pokok yang mem-
ıya:

Struktur Organisasi yang
tegas dan tepat memisahkan
ng jawab fungsional merupakan
tama dalam menciptakan sistem
dalian intern yang baik bagi
aan. Bila suatu perusahaan tidak
ega: dan tepat memisahkan tang-
wab fungsionalnya, akan mem-
eluang terjadinya berbagai pe-
ngan dan penyelewengan.
baliknya pemisahan tanggung
fungsional yang tegas dan tepat
enciptakan kondisi yang mem-
pengendalian dalam perusahaan,
g jawab departemen yang satu
departemen yang lain akan saling
dan memungkinkan terjadinya
heck antar departemen sehingga
adi suatu penyimpangan atau pe-
ngan akan terdeteksi lebih dini.
adaan ini juga memperkecil [illegible]
collution antar departemen
melakukan penyimpangan [illegible]
wengan karena dalam organisasi
emisahkan tanggung jawab yang
an tegas akan dengan mudah
[illegible]
[illegible]
Sistem Otorisasi dan Pro-
Pembukuan yang baik dapat
kan untuk melakukan kontrol
al kegiatan dan transaksi yang

dilakukan perusahaan yang pada akhirnya digunakan sebagai dasar bagi pengambilam keputusan manajemen.

Kesalahan dalam membukukan terjadinya suatu transaksi akan berakibat pada kekeliruan catatan atas keadaan sebenarnya dan memberikan informasi penting dalam pengambilan keputusan manajemen. Dan jika hal itu terjadi berarti Sistem Pengendalian Intern belum dapat diterapkan dengan baik. Sebaliknya bila sistem Otorisasi dan Prosedur Pembukuan dalam perusahaan dapat diterapkan dengan baik akan menjadi alat kontrol manajemen terhadap aktivitas dan kekayaan
pasahan



c. Praktik yang Sehat Prosedur Kerja yang diimplementasikan dalam perusahaan tentunya telah melalui proses pengujian sehingga telah memenuhi kriteria yang paling efektif, efisien dan ekonomis bagi perusahaan. Prosedur kerja yang baik secara tidak langsung akan menjadi alat kontrol yang baik karena akan menimbulkan *cross check* antar departemen yang bisa sangat berguna dalam mengantisipasi penyimpangan dan penyelewengan [illegible]

[illegible]

d. Karyawan yang capable

Faktor manusia memainkan peran yang sangat vital bagi tumbuh dan berkembangnya suatu perusahaan. Mulai dari perencanaan, implementasi hingga pengendalian dan pengawasan sangat dipengaruhi oleh faktor manusia; baik manajer maupun karyawan. Jika sumber daya manusia dalam suatu perusahaan memiliki *capability* yang dapat diandalkan, dengan mudah dan benar mereka akan melaksanakan tugas dan tanggungjawabnya masing-masing sehingga pencapaian tujuan perusahaan akan lebih mudah terwujud.

Untuk dapat memperoleh karyawan dengan kualifikasi yang sesuai dengan kebutuhan, harus dicermati sejak proses seleksi penerimaan yaitu hanya calon karyawan yang memiliki standar sesuai kebutuhan perusahaan yang dapat diterima, jangan sampai hanya karena kolusi dan nepotisme kemudian penerimaan pegawai mengabaikan standar kualitas calon karyawan, hal ini akan menimbulkan dampak cukup besar bagi terpuruknya masa depan perusahaan.

Sistem Pengendalian Intern dalam suatu perusahaan memang tidak secara langsung dapat ditunjukkan dengan angka, sehingga pengukuran baik tidaknya suatu sistem pengendalian dalam perusahaan tidak dapat langsung dihitung secara matematis. Namun demikian, Sistem Pengendalian Intern memiliki peranan yang sangat besar dalam menjaga kekayaan yang dimiliki perusahaan. Karena peranannya yang sangat besar itulah maka menjadi hal yang sangat mendesak bagi manajemen dlam mendesain dan bersama karyawan meng-implementasikan sistem pengendalian [illegible] sehingga tujuan [illegible] yang pada akhirnya [illegible] tujuan perusahaan [illegible]

[illegible]

Stevenson A.M.L
5203099293

BUKU 1 EDISI 5

Sawyer's Internal Auditing

Audit Internal Sawyer

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James H. Scheiner, Ph.D.

Penerbit Salemba Empat

The Institute of Internal Auditors

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Sawyer, Lawrence B.
A. Dittenhofer, Mortimer
H. Scheiner, James

Audit Internal Sawyer/Lawrence B. Sawyer,
Mortimer A. Dittenhofer, James H. Scheiner

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1. Akuntansi I. Judul

kompetensi yang dibutuhkan oleh auditor internal di seluruh dunia. Para peneliti melakukan survei tentang profesi audit internal dari beberapa perspektif: profesi secara umum, pengetahuan audit internal, masa depan profesi, praktik terbaik, kompetensi, dan penilaian kompetensi. Jawaban atas keempat pertanyaan di bawah inilah yang berusaha dicari:

1. Apa yang harus dipahami oleh audit internal di masa depan ditinjau dari sisi global?
2. Kriteria-kriteria apa saja yang harus dimiliki fungsi audit internal yang kompeten dipandang dari sisi praktik terbaik?
3. Kemampuan-kemampuan apa yang disyaratkan untuk fungsi audit internal yang kompeten?
4. Bagaimana cara terbaik menentukan kompetensi auditor internal dan fungsi audit internal?

Studi CFIA menekankan bahwa perubahan yang terjadi secara luas pada lingkungan bisnis harus disandingkan dengan perubahan dalam audit internal, khususnya dalam masalah ekspektasi yang dimiliki organisasi terhadap profesi ini, cara para praktisi melakukan pekerjaannya, dan interaksi antara audit internal dan para penyedia jasa lainnya. Hasil studi menyarankan pelaksanaan tugas audit internal secara penuh, yang mencakup:

- Menjaga hubungan dan komunikasi yang baik di dalam organisasi.
- Menentukan risiko-risiko yang dihadapi saat ini dan di masa yang akan datang.
- Berbagi keahlian, pengetahuan, dan ide-ide.
- Mengembangkan pemahaman di organisasi menyangkut risiko dan kontrol.
- Memfasilitasi pengadopsian dan penerapan *control self-assessment.*

Empat pertanyaan para tim peneliti diintegrasikan dalam lima modul studi:

- *Audit Internal: Perspektif Global*
- *Kompetensi: Praktik Terbaik dan Praktisi yang Kompeten*
- *Pengetahuan Mengenai Audit Internal: Perspektif Global*
- *Masa Depan Audit Internal: Studi Delphi*
- *Menentukan Kompetensi dalam Audit Internal: Struktur dan Metodologi*

Setiap modul merupakan studi yang berbeda dalam hal sumber data, metodologi, dan format. Meskipun modul-modul tersebut terpisah, tetapi mereka saling berkaitan dan memberikan validasi silang bagi hasil-hasil penelitian.

Modul Kompetensi: Praktik Terbaik dan Praktisi yang Kompeten terbagi dalam bagian-bagian yang meliputi Praktik Lapangan; Definisi Fungsional; Unit dan Elemen Kompetensi; dan Kriteria Kinerja, Pedoman, dan Peran-peran Pekerjaan Utama. Penelitian didasarkan pada asumsi bahwa elemen-elemen kompetensi dan kriteria kinerja mereka secara bersama-sama mendefinisikan praktik yang kompeten untuk fungsi audit internal dan menjadi dasar penilaiannya. Elemen-elemen kompetensi dan masing-masing kriteria diartikan sesuai peran-peran kerja sebagai "auditor internal yang baru bekerja," "auditor internal yang kompeten," dan "manajemen audit internal."

- Memberikan definisi standar yang bisa digunakan perusahaan sebagai perbandingan dengan sistem kontrolnya.

Komite tersebut disingkat COSO, yang kemudian memberikan definisi berikut—kontrol internal dirancang untuk memberikan keyakinan yang memadai tentang pencapaian tujuan dalam hal:

- Efektivitas dan efisiensi operasi.
- Keandalan informasi keuangan.
- Ketaatan terhadap hukum dan peraturan yang berlaku.

Komite tersebut menyatakan bahwa proses kontrol dapat membantu dalam mencapai:

- Tujuan dasar usaha dan operasional.
- Pengamanan aktiva.
- Keandalan laporan keuangan.
- Ketaatan terhadap hukum dan peraturan yang berlaku.

Diasumsikan bahwa keandalan laporan operasi termasuk dalam kategori pertama yang berkaitan dengan efisiensi dan efektivitas.

Model COSO

Model COSO terdiri atas lima komponen kontrol internal:

1. Lingkungan Kontrol
2. Penentuan Risiko
3. Aktivitas Kontrol
4. Informasi dan Komunikasi
5. Pengawasan

Aktivitas audit tradisional yang terkait dengan penentuan efisiensi dan efektivitas berada pada komponen ketiga—Aktivitas Kontrol (pemisahan tugas, wewenang dan pertanggungjawaban, otorisasi, pendokumentasian, dan lain-lain). Empat komponen yang lain merupakan tambahan terhadap fungsi kontrol, tetapi dalam banyak kasus juga dipertimbangkan oleh auditor, terutama bila kontrol dinilai tidak efektif. Model yang baru mensyaratkan adanya pertimbangan untuk kelima komponen. Berikut ini penjelasan ringkasnya:

Kontrol Preventif, Detektif, dan Korektif

Kontrol dapat dirancang untuk memiliki berbagai fungsi. Beberapa kontrol diterapkan untuk mencegah hasil-hasil yang tidak diharapkan sebelum terjadi (kontrol preventif). Kontrol lain dirancang untuk menemukan hasil-hasil yang tidak diharapkan pada saat terjadinya (kontrol detektif). Masih ada kontrol lain yang dirancang untuk memastikan bahwa tindakan korektif diambil untuk memperbaiki hal-hal yang tidak diharapkan atau untuk memastikan bahwa hal-hal tersebut tidak terulang (kontrol korektif). Semua kontrol, secara bersama-sama, berfungsi untuk memastikan bahwa tujuan atau sasaran manajemen akan tercapai.

Kontrol preventif lebih efektif dari segi biaya dibandingkan kontrol detektif. Ketika diterapkan ke dalam sebuah sistem, kontrol preventif dapat mencegah kekeliruan dan oleh karena itu mencegah biaya perbaikan. Kontrol preventif bisa mencakup, misalnya: karyawan yang kompeten dan dapat dipercaya; pemisahan tugas untuk mencegah pelanggaran yang disengaja, otorisasi yang layak untuk mencegah penggunaan sumber daya organisasi dengan tidak semestinya; perbaikan menggunakan komputer untuk mendeteksi dan mencegah transaksi yang tidak semestinya; dokumentasi dan catatan yang memadai serta prosedur pencatatan yang layak untuk mencegah transaksi yang tidak semestinya; dan kontrol fisik atas aktiva untuk mencegah penyalahgunaan atau pencurian.

Kontrol detektif biasanya lebih mahal dibandingkan kontrol preventif, tetapi tetap saja diperlukan. Pertama, kontrol detektif mengukur efektivitas kontrol preventif. Kedua, beberapa kekeliruan tidak bisa secara efektif dikendalikan oleh sistem pencegahan; kekeliruan tersebut harus dideteksi saat terjadi. Kontrol detektif mencakup pemeriksaan dan perbandingan, seperti catatan kinerja dan pemeriksaan independen atas kinerja. Kontrol detektif juga mencakup sarana kontrol seperti rekonsiliasi bank, konfirmasi saldo bank, perhitungan kas, rekonsiliasi rincian piutang usaha ke akun pengendali piutang usaha, pemeriksaan fisik persediaan dan analisis varians, konfirmasi dengan pemasok utang usaha, penggunaan teknik-teknik komputer seperti limit transaksi, kata kunci, pengeditan, dan sistem pemeriksaan seperti audit internal.

Kontrol korektif dilakukan bila terjadi hal-hal yang tidak semestinya dan telah dideteksi. Semua kontrol detektif tidak ada gunanya bila kelemahan yang telah diidentifikasi tidak diperbaiki atau dianggap tidak masalah bila terulang. Oleh karena itu, manajemen harus mengembangkan sistem yang tetap menyoroti kondisi-kondisi yang tidak diinginkan sampai diperbaiki, dan jika layak, harus menetapkan prosedur-prosedur untuk mencegah terulangnya kondisi tersebut. Pendokumentasian dan sistem pelaporan membuat masalah-masalah tetap berada di bawah pengawasan manajemen sampai diselesaikan atau kerusakan diperbaiki. Jadi kontrol korektif menutup lingkaran yang dimulai dari pencegahan kemudian deteksi hingga koreksi. Berikut ini contoh ketiga kontrol tersebut:

> Kapal derek yang memindahkan barang-barang berat dari satu tempat ke tempat lain memiliki masalah keamanan. Pengait yang tidak layak pakai dapat menyebabkan barang-barang berat terlepas sehingga timbul kerusakan dan kecelakaan.

Pelaporan

Pada kebanyakan organisasi, manajemen berfungsi dan membuat keputusan berdasarkan laporan yang diterima. Oleh karena itu, laporan haruslah tepat waktu, akurat, bermakna, dan ekonomis. Berikut ini beberapa prinsip untuk menetapkan sistem **pelaporan** (*reporting*) internal yang memuaskan:

- Laporan harus dibuat sesuai dengan tanggung jawab yang diberikan.
- Individu-individu atau unit-unit harus diminta melaporkan hal-hal yang menjadi tanggung jawabnya.
- Biaya mengakumulasi data dan menyiapkan laporan harus dibandingkan dengan manfaat yang akan didapat.
- Laporan harus sesederhana mungkin, dan konsisten dengan sifat subjek yang menjadi masalah. Laporan harus berisi informasi yang melayani kebutuhan pengguna. Klasifikasi dan terminologi umum harus digunakan sebanyak mungkin untuk menghindari kebingungan.
- Sedapat mungkin laporan kinerja memperlihatkan perbandingan dengan standar biaya, kualitas, dan kuantitas yang ditetapkan. Biaya-biaya yang bisa dikendalikan harus dipisahkan.
- Jika kinerja tidak bisa dilaporkan secara kuantitatif, laporan harus dirancang untuk menekankan pengecualian atau hal-hal lain yang membutuhkan perhatian manajemen.
- Agar bisa bermanfaat maksimal, laporan haruslah tepat waktu. Laporan yang tepat waktu yang sebagian didasarkan pada estimasi bisa jadi lebih berguna dibandingkan laporan yang lebih tepat tetapi terlambat.
- Penerima laporan harus ditanyakan secara periodik untuk mengetahui apakah mereka masih membutuhkan laporan yang diterima, atau apakah ada yang bisa diperbaiki dari laporan tersebut.

Dampak Regulasi terhadap Kontrol

Terjadinya Perubahan Besar

Kontrol internal pernah menjadi hak dan alat prerogatif manajemen. Eksekutif perusahaan memutuskan kontrol seperti apa yang akan diterapkan atau tidak diterapkan pada usaha mereka. Jika kontrol dianggap teralu berat, menghabiskan biaya, atau tidak diinginkan, manajemen tidak akan menerapkannya atau justru menghilangkannya. Jika situasi menyebabkan adanya risiko, manajemen akan berinisiatif untuk memutuskan apakah akan menerapkan kontrol atau mengambil risiko tersebut.

Division of Corporation Finance
Office of the Chief Accountant
U.S. Securities and Exchange Commission
May 16, 2005

Staff Statement on Management's Report on Internal Control Over Financial Reporting

This statement provides the staff's views on certain issues raised in the implementation of Section 404 of the Sarbanes-Oxley Act of 2002.[1] For further information, please contact Jonathan Ingram in the Office of Chief Counsel in the Division of Corporation Finance at (202) 551-3500 or Esmeralda Rodriguez or Nancy Salisbury in the Office of the Chief Accountant at (202) 551-5300.

A. Feedback Received on the Implementation of the Internal Control Reporting Provisions

Section 404 of the Sarbanes-Oxley Act of 2002[2] directed the Commission to adopt rules requiring each reporting company, other than a registered investment company, to include in its annual report a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting, as well as an assessment of the effectiveness of those internal controls. Section 404, and the rules and standard promulgated relating to the Act, also specifies that each registered public accounting firm that prepares or issues an audit report on a company's annual financial statements must attest to, and report on, management's assessment of internal control over the financial reporting in accordance with standards set by the Public Company Accounting Oversight Board (PCAOB).

Accelerated filers[3] were required to comply with the internal control reporting provisions for the first time in connection with their fiscal years ending on or after November 15, 2004.. The Section 404 reporting requirements represent a major change for management and auditors and, during and after this initial year of implementation, the Commission has actively sought input to assess the impact of these new reporting requirements.

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[1] This staff statement represents the views of the Division of Corporation Finance and the Office of the Chief Accountant. This staff statement is not a rule, regulation, or statement of the Securities and Exchange Commission. Further, the Commission has neither approved nor disapproved its content.
[2] 15 U.S.C. 7262.
[3] The term "accelerated filer" is defined in Exchange Act Rule 12b-2.

On April 13, 2005, the Commission hosted an all day roundtable discussion about the implementation of the internal control reporting provisions. A broad range of interested persons, including representatives of public companies (domestic and foreign), auditors, investors, members of the legal community, and the board members of the PCAOB, participated in the discussion. The Commission also invited written submissions from the public regarding Section 404.[4] The staff wishes to express its appreciation for the efforts expended by so many in providing their views and other information on this subject, which significantly contributed to the Commission's and staff's understanding of first year implementation.

The feedback made clear that companies have realized improvements to their internal controls as a result of implementing the requirements, and that the requirements have led to an improved focus on internal controls throughout the organization.[5] However, the feedback also identified implementation areas that need further attention or clarification to reduce any unnecessary costs and other burdens without jeopardizing the benefits of the new requirements.[6]

The staff is providing this guidance to help address those areas. In general, this statement addresses the following areas:

- The purpose of internal control over financial reporting;
- Reasonable assurance, risk-based approach, and scope of testing and assessment;
- Evaluating internal control deficiencies;
- Disclosures about material weaknesses;
- Information technology issues;
- Communications with auditors; and
- Issues related to small business and foreign private issuers.

An overarching principle of this guidance is the responsibility of management to determine the form and level of controls appropriate for each organization and to scope their assessment and

[4] Those submissions have been posted on the Commission's website, see http://www.sec.gov/news/press/4-497.shtml.
[5] For example, refer to comment letters (File Number 4-497) of: Forest City Enterprises, Glass Lewis, J.P. Morgan & Company, Merck & Company, and Pepsico.
[6] For example, refer to comment letters (File Number 4-497) of: Boston Properties, Inc., Computer Services Corporation, Intel Corporation, Microsoft Corporation, and The Committee on Corporate Reporting of Financial Executives International. See also the transcript from the roundtable discussion - Panel 1, Panel 3, and Panel 6.

testing accordingly. One size does not fit all and control effectiveness is affected by many factors.

B. The Purpose of Internal Control Over Financial Reporting

An overall purpose of internal control over financial reporting is to foster the preparation of reliable financial statements. Reliable financial statements must be materially accurate. Therefore, a central purpose of the assessment of internal control over financial reporting is to identify material weaknesses that have, as indicated by their very definition, more than a remote likelihood of leading to a material misstatement in the financial statements. While identifying control deficiencies and significant deficiencies represents an important component of management's assessment, the overall focus of internal control reporting should be on those items that could result in material errors in the financial statements.[7]

The establishment and maintenance of internal accounting controls has been required of public companies since the enactment of the Foreign Corrupt Practices Act of 1977 (FCPA).[8] The significance of Section 404 of the Act is that it re-emphasizes the important relationship between the maintenance of effective internal control over financial reporting and the preparation of reliable financial statements. Effective internal control over financial reporting can also help companies deter fraudulent financial accounting practices or detect them earlier and perhaps reduce their adverse effects. However, due to their inherent limitations, internal controls cannot prevent or detect every instance of fraud. Controls are susceptible to manipulation, especially in instances of fraud caused by the collusion of two or more people including senior management. Nonetheless, that limitation does not undercut the need for Section 404 and the improvements it has engendered and will continue to engender.

In adopting its rules implementing Section 404, the Commission expressly declined to prescribe the scope of assessment or the amount of testing and documentation required by management.[9] The scope and process of the assessment should be reasonable, and the assessment (including testing) should be supported by a reasonable level of evidential matter. Each company should

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[7] This focus on material weaknesses will, in the staff's opinion, lead to a better understanding by investors of internal control over financial reporting, as well as its inherent limitations. The staff further believes that the Commission's rules implementing Section 404, by providing for public disclosure of material weaknesses, concentrates attention on the most important internal control issues.

[8] Title I of Pub. L. 95-213 (1977).

[9] Instruction 1 to Item 308 of Regulation S-K provides that "The registrant must maintain evidential matter, including documentation, to provide reasonable support for management's assessment of the effectiveness of the registrant's internal control over financial reporting."

also use informed judgment in documenting and testing its controls to fit its own operations, risks and procedures. Management should use its own experience and informed judgment in designing an assessment process that fits the needs of that company.[10] Management should not allow the goal and purpose of the internal control over financial reporting provisions – the production of reliable financial statements – to be overshadowed by the process.

C. Reasonable Assurance, Risk-based Approach and Scope of Testing and Assessment

In the feedback received, many questions were raised about the judgment and processes used to determine the appropriate level of identification and testing of controls necessary in order to achieve reasonable assurance regarding the reliability of the financial statements.

The Concept of Reasonable Assurance

Management is required to assess whether the company's internal control over financial reporting is effective in providing reasonable assurance regarding the reliability of financial reporting.[11] Management is not required by Section 404 of the Act to assess other internal controls. Further, while "reasonable assurance" is a high level of assurance, it does not mean absolute assurance. As noted earlier, internal control over financial reporting cannot prevent or

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[10] This point also is made in one of the publicly available and commonly used assessment tools – the third volume of the report by The Committee of Sponsoring Organizations of the Treadway Commission, or COSO, Internal Control – Integrated Framework: Evaluation Tools. That volume cautioned that "because facts and circumstances vary between entities and industries, evaluation methodologies and documentation will also vary. Accordingly, entities may use different evaluation tools, or use other methodologies utilizing different evaluative techniques."

[11] The Commission defined, in Exchange Act Rules 13a-15(f) and 15d-15(f), "internal control over financial reporting" as:

> A process designed by, or under the supervision of, the issuer'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:
>
> (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.

detect all errors, misstatements, or fraud. Rather, the "reasonable assurance" referred to in the Commission's implementing rules relates back to similar language in the FCPA. Exchange Act Section 13(b)(7) defines "reasonable assurance" and "reasonable detail" as "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs."[12] The Commission has long held that "reasonableness" is not an "absolute standard of exactitude for corporate records."[13]

In addition, the staff recognizes that while "reasonableness" is an objective standard, there is a range of judgments that an issuer might make as to what is "reasonable" in implementing Section 404 and the Commission's rules. Thus, the terms "reasonable," "reasonably" and "reasonableness" in the context of Section 404 implementation do not imply a single conclusion or methodology, but encompass the full range of potential conduct, conclusions or methodologies upon which an issuer may reasonably base its decisions. Different conduct, conclusions and methodologies by different issuers in a given situation do not by themselves mean that implementation by any of those issuers is unreasonable. This also suggests that registered public accounting firms should recognize that there is a zone of reasonable conduct by issuers that should be recognized as acceptable in the implementation of Section 404. While that zone is not unlimited, the staff expects that it will be rare when there is only one acceptable choice in implementing Section 404 in any given situation.

Top-Down / Risk-Based Assessments

The feedback indicated that one reason why too many controls and processes were identified, documented and tested was that in many cases neither a top-down nor a risk-based approach was effectively used. Rather, the assessment became a mechanistic, check-the-box exercise. This was not the goal of the Section 404 rules, and a better way to view the exercise emphasizes the particular risks of individual companies. Indeed, an assessment of internal control that is too formulaic and/or so detailed as to not allow for a focus on risk may not fulfill the underlying purpose of the requirements. The desired approach should devote resources to the areas of greatest risk and avoid giving all significant accounts and related controls equal attention without regard to risk.

[12] 15 U.S.C. 78m(b)(7). The conference committee report on amendments to the FCPA also noted that the standard "does not connote an unrealistic degree of exactitude or precision. The concept of reasonableness of necessity contemplates the weighing of a number of relevant factors, including the costs of compliance." Cong. Rec. H2116 (daily ed. April 20, 1988).
[13] Exchange Act Release No. 17500 (January 29, 1981), 46 FR 11544 (February 9, 1981).

The assessment of internal control over financial reporting will be more effective if it focuses on controls related to those processes and classes of transactions for financial statement accounts and disclosures that are most likely to have a material impact on the company's financial statements. Employing such a top-down approach requires that management apply in a reasonable manner its cumulative knowledge, experience and judgment to identify the areas of the financial statements that present significant risk that the financial statements could be materially misstated and then proceed to identify relevant controls and design appropriate procedures for documentation and testing of those controls. For instance, the application of judgment by management and the auditor will typically impact the nature, extent and timing of control testing such that the level of testing performed for a low risk account will likely be different than it will be for a high risk account. In performing these steps, management and auditors should keep the "reasonable assurance" standard in mind.

Scope of Assessment

An issue frequently cited in the comments concerned the determination of the appropriate scope of management's assessment. Many felt that overly conservative interpretations of the applicable requirements and a hesitancy by the independent auditor to use professional judgment in evaluating management's assessment resulted in many cases in too many controls being identified, documented and tested.

As previously discussed, the staff believes that management should use a top-down, risk-based approach in determining significant accounts and related significant processes and relevant assertions. The natural result of such an approach is that management would devote greater attention and resources to the areas of greater risk.

When identifying significant accounts and related significant processes in order to determine the scope of its assessment, management generally will consider both qualitative and quantitative factors. Qualitative factors include the risk associated with the various accounts and their related processes, as discussed previously. In addition to considering qualitative factors, the staff understands that management generally establishes quantitative thresholds to be used in identifying significant accounts subject to the scope of internal control testing. The use of a percentage as a minimum threshold may provide a reasonable starting point for evaluating the significance of an account or process; however, judgment, including a review of qualitative factors, must be exercised to determine if amounts above or below that threshold must be evaluated.

Once the significant accounts and their related significant processes are identified, management must focus on the controls to be tested that are relevant to those processes. We believe that some of the large numbers of controls identified for testing during the first year of implementation may, in part, represent individual steps within what may constitute a broader control. In performing future assessments, management may wish to step back from focusing on the detail to consider whether combinations of controls previously identified individually constitute the actual control that contributes to financial statement assurance. Rather than identifying, documenting, and testing each individual step involved in a broader control definition, management's focus should be on the objective of controls, and testing the effectiveness of the combination of detailed steps that meet the broader control objective. Management may determine that not every individual step comprising a control is required to be tested in order to determine that the overall control is operating effectively.

The staff also expects that through the natural learning process management will achieve efficiencies as they complete future assessments of internal control. For example, as discussed above, management's knowledge of the prior year's assessment results will impact its current year risk-based analysis of the significant accounts and the related required documentation and testing that may be necessary. Management may determine that certain controls require more extensive testing, while other controls require little testing in a given year. Additionally, in reaching its conclusion of reasonable assurance, management may find it appropriate to adjust the nature, extent and timing of testing from year to year – in some years delving deeply into selected internal control areas while performing less extensive testing in other areas and changing that focus from year to year.

The staff believes that efficient and effective assessments depend on internal audit and other company personnel and external auditors who are "on the ground" closest to the assessment. It is at that level where the unique circumstances of any particular situation can best be evaluated. It is thus critically important that company and auditor personnel have the requisite skills, training, and judgment to make reasonable assessments. The staff believes that the ability to make such assessments in a consistent and sound manner will improve with experience and that it is the exercise of judgment which makes the audit a professional responsibility.[14]

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[14] In this regard, both at the roundtable and in comments, companies and their representatives raised issues regarding auditor preparedness for first-time implementation. This is the first time such work has been undertaken *en masse*. Comments reflected concerns including shortages of qualified resources at the auditor, consultant and preparer level; indecision by management and auditors as to acceptable levels of control documentation and testing; shifts in direction after work had commenced; pressures on companies to commit firmly to the precise timing of work because auditor resources were limited; inexperienced staff; auditors reluctant to make decisions without national office support; pressures and long hours expended by auditors and companies to complete the control evaluation

Financial Periods Used to Assess Account Significance versus Periods Used to Assess Significance of a Deficiency

When management uses a top-down approach that begins with the financial statements, it will necessarily use qualitative and quantitative assessments to identify significant accounts and plan the scope of management's testing. Companies generally should determine the accounts included within their Section 404 assessment by focusing on annual and company measures rather than interim or segment measures.[15] If management identifies a deficiency when it tests a control, however, at that point it must measure the significance of the deficiency by using both quarterly and annual measures, also considering segment measures where applicable.

Timing of Management's Testing

The feedback also indicated that some auditors have been unwilling to accept management's testing and other procedures performed during the year as evidence that management's assessment of the effectiveness of internal control over financial reporting is fairly stated.[16] While Section 404 of the Act and the Commission's rules require that management's and auditor's reports must be "as of" year-end, this does not mean that all testing must be done within the period immediately surrounding the year-end close. In fact, we believe that effective testing and assessment may, and in most cases preferably would, be accomplished over a longer period of time. In its adopting release, the Commission expressly noted that testing may be done over a period of time.[17]

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work; communication difficulties between auditors and management; and auditor concern over the PCAOB inspection process impacting their decisions as to the appropriate level of documentation and testing. Comments also reflect that the initial assessments involved much catch-up in the form of deferred maintenance in documenting control systems (especially post Y2K). The staff believes that many of these concerns will subside over time as the experience base increases and as management and auditors gain confidence in the judgments they are required to make. The staff believes it is important to separate the non-recurring first time implementation issues from issues that may have a longer-term impact on the scope and quality of Section 404 work.

[15] The staff acknowledges, however, there may be certain limited circumstances where the annual company results are not the most appropriate measure. For example, where a company has one or two key segments that are driving the business and are material to investors, management also may want to consider those segment measures to determine the required level of documentation and testing. As another example, there may also be limited circumstances where interim results drive the business (such as the holiday season for retailers) and are similarly of significant interest to investors.

[16] See the transcript from the roundtable discussion - Panel 3.

[17] "[S]ome controls operate continuously while others operate only at certain times, such as the end of the fiscal year. We believe that each company should be afforded the flexibility to design the testing of its system of internal control over financial reporting to fit its particular circumstances. The management of each company should

Management's daily interaction with its internal control system provides it with a broad array of opportunities to evaluate its controls during the year and, in many cases, to use that work as its basis, at least in part, to reasonably conclude that its controls are in place and operating effectively as of the end of its fiscal year. For example, management might determine that controls operate effectively through direct and ongoing monitoring of the operation of controls. This might be accomplished through regular management and supervisory activities, monitoring adherence to policies and procedures, and other actions. As a result, management may be able to test a substantial number of controls at a point in time prior to its fiscal year-end, and determine through its direct and ongoing monitoring of the operation of the controls that they also function effectively as of the fiscal year-end date, without performing further detailed testing.

D. Evaluating Internal Control Deficiencies

If control deficiencies are identified, an important part of the assessment of internal control over financial reporting is the consideration of the significance of those deficiencies and whether the risk is mitigated by compensating controls. As with determining the scope of the assessment, management must exercise judgment in a reasonable manner in the evaluation of deficiencies in internal control over financial reporting, and such evaluations may appropriately consider both qualitative and quantitative analyses. Among other things, the qualitative analysis should factor in the nature of the deficiency, its cause, the relevant financial statement assertion the control was designed to support, its effect on the broader control environment and whether other compensating controls are effective.

One particular area brought to the staff's attention involved financial statement restatements due to errors. Neither Section 404 nor the Commission's implementing rules require that a material weakness in internal control over financial reporting must be found to exist in every case of restatement resulting from an error. Rather, both management and the external auditor should use their judgment in assessing the reasons why a restatement was necessary and whether the need for restatement resulted from a material weakness in controls. Such an evaluation should be based on all the facts and circumstances, including the probability of occurrence in light of the assessed effectiveness of the company's internal control, keeping in mind that internal control over financial reporting is defined as operating at the level of "reasonable assurance."

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perform assessments of the design and operation of the company's entire system of internal control over financial reporting over a period of time that is adequate for it to determine whether, as of the end of the company's fiscal year, the design and operation of the company's internal control over financial reporting are effective." Section II.C.3 to Release No. 33-8238 (June 5, 2003).

E. Disclosures about Material Weaknesses

A number of companies have reported material weaknesses in their internal control over financial reporting in this first year of implementation. When a company identifies a material weakness, and such material weakness has not been remediated prior to its fiscal year-end, it must conclude that its internal control over financial reporting is ineffective. The Commission's rule implementing Section 404 was thus intended to bring information about material weaknesses in internal control over financial reporting into public view. The staff believes that, as a result, companies should consider including in their disclosures:

- the nature of any material weakness,
- its impact on financial reporting and the control environment, and
- management's current plans, if any, for remediating the weakness.

Disclosure of the existence of a material weakness is important, but there is other information that also may be material and necessary for an overall picture that is not misleading.[18] There are many different types of material weaknesses and many different factors that may be important to the assessment of the potential effect of any particular material weakness. We received feedback suggesting that some companies believe that they are not permitted to distinguish among reported material weaknesses.[19] While management is required to conclude and state in its report that internal control over financial reporting is ineffective when there is one or more material weakness, companies may, and are strongly encouraged to, provide disclosure that allows investors to assess the potential impact of each particular material weakness. The disclosure will likely be more useful to investors if management differentiates the potential impact and importance to the financial statements of the identified material weaknesses, including distinguishing those material weaknesses that may have a pervasive impact on internal control over financial reporting from those material weaknesses that do not. The goal underlying all disclosure in this area is to provide increased investor information so that an investor who chooses to do so can treat the disclosure of the existence of a material weakness as the starting point for analysis rather than the only point available.

[18] See Exchange Act Rule 12b-20.
[19] See transcript for roundtable discussion - Panel 2.

F. Information Technology Issues

Information Technology Internal Controls

The feedback revealed different views that may have developed as to the appropriate extent of required documentation and testing necessary for information technology, or IT, internal controls, particularly with respect to general IT controls (e.g. controls over program development, program changes, computer operations, and access to programs and data). While the extent of documentation and testing requires the use of judgment, the staff expects management to document and test *relevant* general IT controls in addition to appropriate application-level controls that are designed to ensure that financial information generated from a company's application systems can reasonably be relied upon. For purposes of the Section 404 assessment, the staff would not expect testing of general IT controls that do not pertain to financial reporting. A company's finance and IT departments should interact closely to ensure that the proper IT controls are identified.

We have also been asked whether those companies that decide to use proprietary IT frameworks[20] as a guide in conducting the IT portion of their overall COSO framework assessment are required to apply all of the components related to general IT controls that may be included in such frameworks. While the use of a separate, specific IT framework is not required, the staff understands that management of some companies has found certain parts of available frameworks to be useful. In establishing the scope of its IT assessment, management should apply reasonable judgment and consider how the IT systems impact internal control over financial reporting. Because Section 404 is not a one-size-fits-all approach to assessing controls, it is not possible for us to provide a list of the exact general IT controls that should be included in an assessment for Section 404 purposes. However, the staff does not believe it necessary for purposes of Section 404 for management to assess all general IT controls, and especially not those that primarily pertain to the efficiency or effectiveness of the operations of the organization but are not relevant to financial reporting.

[20] For example, refer to comment letters (File Number 4-497): William T. Archey, American Electronics Association; Jane Windmeier, Target; and Rod Scott, R.G. Scott & Associates, LLC which refer to CobiT (Control Objectives for Information and related Technology), one such proprietary framework developed by the IT Governance Institute and the CobiT Steering Committee in 2000.

Information Technology System Implementations and Upgrades

We received considerable feedback regarding the impact of the Section 404 assessment on the implementation of new IT systems and upgrades to existing systems. The feedback indicated that some companies have delayed installations of new IT systems or upgrades due to time limitations for installing, testing, and remediating control deficiencies before the company's fiscal year-end.

The staff understands the importance of new IT systems and upgrades and that they are often introduced to improve internal control. Registrants should continue to make appropriate improvements in IT systems. Of course, and notwithstanding the internal control reporting requirements, companies are required to prepare reliable financial statements following the implementation of the new information systems. In that sense, the goals of Section 404 align with management's existing responsibilities when undertaking an IT conversion or implementation project.

Some of the feedback requested that management be allowed to exclude new IT systems and upgrades implemented in the later part of a fiscal year from the scope of management's assessment for that year, suggesting an analogy be made to new business acquisitions and the guidance issued by the staff in Question 3 of its Frequently Asked Questions.[21] However, with respect to system changes, management can plan, design, and perform preliminary assessments of internal controls in advance of system implementations or upgrades. As noted elsewhere in this statement, not all testing must occur at year end. As a result, the staff does not believe it is appropriate to provide an exclusion by management of new IT systems and upgrades from the scope of its assessment of internal control over financial reporting.

G. Communications with Auditors

Feedback from both auditors and registrants revealed that one potential unintended consequence of implementing Section 404 and Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with An Audit of Financial Statements*, has been a chilling effect in the level and extent of communications between auditors and management regarding accounting and financial reporting issues. Historically, the external auditor may have provided management with advice, based on the auditor's knowledge, experience and judgment in accounting, auditing, and financial reporting matters. Since introduction of the Act and the

[21] Management's Report on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports – Frequently Asked Questions (revised October 6, 2004).

new auditing requirements, the staff understands that management at times has hesitated to ask auditors technical accounting, auditing, and financial reporting questions or to provide auditors with early drafts of the financial statements (which, due to their draft nature, may contain errors), because of a concern that these actions could result in the unwarranted identification of internal control deficiencies by the auditors. Additionally, the staff understands that auditors also have a heightened concern that providing management with advice might impair the auditor's independence.

The Commission's auditor independence requirements with respect to services provided by auditors are largely predicated on four basic principles.[22] In addition to these four basic principles, the Commission's rules also specifically identified nine categories of prohibited services.[23] The auditor's discussing and exchanging views with management does not in itself violate the independence principles, nor does it fall into one of those nine prohibited categories of services. The staff supports a strong audit profession where a hallmark of its professionalism is to exercise sound judgment in both the audit and in ongoing dialogue with management.

The staff recognizes that questions arise in certain circumstances as to the proper application of accounting standards. Investors benefit when auditors and management engage in dialogue, including regarding new accounting standards and the appropriate accounting treatment for complex or unusual transactions. The staff believes that as long as management, and not the auditor, makes the final determination as to the accounting used, including determination of estimates and assumptions, and the auditor does not design or implement accounting policies, such auditor involvement is appropriate and is not of itself indicative of a deficiency in the registrant's internal control over financial reporting. Further, timely dialogue between

[22] Those principles are: (1) an auditor cannot function in the role of management, (2) an auditor cannot audit his or her own work, (3) an auditor cannot serve in an advocacy role for his or her client and (4) an auditor and audit client cannot have a relationship that creates a mutual or conflicting interest. See Preliminary Note to Rule 2-01 of Regulation S-X. These basic principles are consistent with the guidance offered in the Independence Standard Board's Interpretation 99-1, *Impact on Auditor Independence of Assisting Clients in the Implementation of FAS 133 (Derivatives)*, which specifically addressed the topic of auditor/client communications in the context of applying the new derivatives standard. The PCAOB adopted this interpretation as part of its interim auditing standards.

[23] The categories of prohibited services include: bookkeeping or other services related to the accounting records or financial statements of the audit client; financial information system design and implementation; appraisal or valuation services, fairness opinions, or contribution-in-kind reports; actuarial services; internal audit outsourcing; management functions or human resources; broker or dealer, investment advisor, or investment banking services; legal services and expert service unrelated to the audit; and any other service that the Commission or PCAOB determines, by regulation, is impermissible. See Item 2-01(c)(4) of Regulation S-X, 17 CFR 210. 2-01(c)(4); Exchange Act Section 10A(g).

management and the auditor may positively impact audit quality and the quality of financial reporting.

The staff believes that management should not be discouraged from providing its auditors with draft financial statements (including drafts that may be incomplete in certain respects). Providing draft financial statements promotes communication between the auditor and management, and all parties should recognize the draft nature of the information. In the staff's view, errors in draft financial statements in and of themselves should not be the basis for the determination by a company or an auditor of a deficiency in internal control over financial reporting. Rather, as with all cases of identifying deficiencies, management and auditors should determine whether a deficiency exists in the processes of financial statement preparation. That identification is essentially independent of whether an error exists in draft financial statements and who found it.

H. Small Business Issuers

Some have complained that the costs and burdens of assessment and reporting requirements on internal control over financial reporting may fall disproportionately on smaller businesses. The staff will continue to assess the effects of the internal control reporting rules on smaller public companies who have not yet been required to comply with the Act's provisions. To do so, the Commission established the Securities and Exchange Commission Advisory Committee on Smaller Public Companies, which will consider, among other things, the effect of the internal control provisions on smaller public companies. Also, at the request of the Commission staff, a task force of COSO has been established to develop additional guidance on applying COSO's framework for internal control over financial reporting to smaller companies.

I. Foreign Private Issuers

The staff is also continuing to assess the effects of the internal control reporting requirements on foreign private issuers, who are not yet required to comply with Section 404, although a number have done so. Representatives of several foreign private issuers participated in the Commission's roundtable discussion, and a number of other foreign private issuers and other interested parties have provided feedback in response to the Commission's request.

J. Conclusion

The staff will continue to evaluate the implementation of Section 404. There is a desire for the sharing of best practices so that companies and auditors can benefit from the substantial learning that has taken place from the first year of implementation, and we strongly encourage those efforts. The staff desires that the benefits are achieved in a sensible and cost-effective manner. We will continue to consider whether there are other ways we can make the process more efficient and effective while preserving the benefits.[24]

[24] Additionally, the staff believes that as a result of the first year Section 404 work there is now a substantial amount of data available relating to control deficiencies, material weaknesses and audit behavior, much of which would be useful to research by academics and other interested parties. To that end, the staff welcomes research on this data.

Corrected Version (To Conform to Release Published in the Federal Register)

SECURITIES AND EXCHANGE COMMISSION

17 CFR PARTS 210, 228, 229, 240 and 249

[RELEASE NOS. 33-8730A; 34-54294A; File No. S7-06-03]

RIN 3235-AI79

INTERNAL CONTROL OVER FINANCIAL REPORTING IN EXCHANGE ACT PERIODIC REPORTS OF FOREIGN PRIVATE ISSUERS THAT ARE ACCELERATED FILERS

AGENCY: Securities and Exchange Commission.

ACTION: Final rule; extension of compliance dates.

SUMMARY: We are extending the compliance date that was published on March 8, 2005, in Release No. 33-8545 [70 FR 11528], for foreign private issuers that are accelerated filers, but not large accelerated filers, for amendments to Forms 20-F and 40-F that require a foreign private issuer to include in its annual reports an attestation report by the issuer's registered public accounting firm on management's assessment on internal control over financial reporting.

DATES: Effective Date: September 14, 2006, except Temporary §210.2-02T, Temporary Item 15T of Form 20-F, and Temporary Instruction 2T of General Instruction B(6) of Form 40-F are effective from September 14, 2006, to December 31, 2007.

Compliance Dates: The compliance dates are extended as follows: A foreign private issuer that is an accelerated filer, but not a large accelerated filer, under the definition in Rule 12b-2 of the Securities Exchange Act of 1934, and that files its annual report on Form 20-F or Form 40-F, must begin to comply with the requirement to provide the auditor's attestation report on internal control over financial reporting in the annual report filed for its first fiscal year ending on or after July 15, 2007. Furthermore, until this type of foreign private issuer becomes subject to the auditor attestation report requirement, the registered public accounting firm retained by the issuer need not comply with the obligation in Rule 2-02(f) of Regulation S-X. Rule 2-02(f) requires every registered public accounting firm that issues or prepares an accountant's report that is included in an annual report filed by an Exchange Act reporting company (other than a registered investment company) containing an assessment by management of the effectiveness of the company's internal control over financial reporting to attest to, and report on, such assessment.

FOR FURTHER INFORMATION CONTACT: Michael Coco, Special Counsel, Office of International Corporate Finance, Division of Corporation Finance, at (202) 551-3450, U.S. Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-3628.

SUPPLEMENTARY INFORMATION: On June 5, 2003,[1] the Commission adopted several amendments to its rules and forms implementing Section 404 of the Sarbanes-Oxley Act of 2002.[2] Among other things, these amendments require companies, other than registered investment companies, to include in their annual reports a report of management on the effectiveness of the company's internal control over financial reporting, and an accompanying auditor's attestation report, and to evaluate, as of the end of each fiscal period, any change in the company's internal control over financial reporting that occurred during the period that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

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[1] See Release No. 33-8238 (June 5, 2003) [68 FR 36636].

[2] 15 U.S.C. 7262.

In February 2004, we approved an extension of the original compliance dates for the amendments related to internal control over financial reporting.[3] Specifically, we extended the compliance dates for companies that are accelerated filers, as defined in Exchange Act Rule 12b-2,[4] to fiscal years ending on or after November 15, 2004, and for non-accelerated filers[5] and all foreign private issuers filing annual reports on Form 20-F or 40-F,[6] to fiscal years ending on or after July 15, 2005. In March 2005, we approved a further one-year extension of the compliance dates for non-accelerated filers and for all foreign private issuers filing annual reports on Form 20-F or 40-F[7] and acknowledged the significant efforts that were being expended by many foreign private issuers to comply with International Financial Reporting Standards.

Most recently, in September 2005, we again extended for another one year period the compliance dates for the internal control over financial reporting requirements applicable to non-accelerated filers, including foreign private issuers that are non-accelerated filers.[8] Based on the September 2005 extension, a foreign private issuer that is a non-accelerated filer currently is scheduled to become subject to compliance with the internal control over financial reporting

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[3] See Release No. 33-8392 (February 24, 2004) [69 FR 9722].

[4] 17 CFR 240.12b-2.

[5] The term "non-accelerated filer" is not defined in our rules, but we use it throughout this release to refer to an Exchange Act reporting company that does not meet the Exchange Act Rule 12b-2 definition of either an "accelerated filer" or a "large accelerated filer."

[6] 17 CFR 249.20f and 249.40f.

[7] Release No. 33-8545 (March 2, 2005) [70 FR 11528].

[8] Release No. 33-8618 (September 22, 2005) [70 FR 56825]. Prior to December 1, 2005, "accelerated filer" status did not directly affect a foreign private issuer filing its annual reports on Form 20-F or 40-F because we had not accelerated the filing deadlines for those forms, even though the Rule 12b-2 definition of "accelerated filer" did not expressly exclude foreign private issuers by its terms. After December 1, 2005, however, as a result of a change made as part of the Commission's Securities Offering Reform final rules, a foreign private issuer meeting the accelerated filer definition, and filing its annual report on Form 20-F, became subject to a new requirement in Item 4A of Form 20-F to disclose unresolved staff comments.

requirements beginning with the annual report filed for its first fiscal year ending on or after July 15, 2007.

In a companion release also being issued today,[9] we propose both to further extend the management assessment compliance date for non-accelerated filers with a fiscal year ending on or after July 15, 2007, but before December 15, 2007, and to also extend the compliance date relating to the auditor's attestation report on internal control over financial reporting for all non-accelerated filers until fiscal years ending on or after December 15, 2008.

Pursuant to the compliance dates established in the March 2005 release, a foreign private issuer that is either an accelerated filer[10] or a large accelerated filer,[11] and that files its annual reports on Form 20-F or 40-F, currently is scheduled to comply with the internal control over financial reporting requirements beginning with the annual report filed for its first fiscal year ending on or after July 15, 2006.

In this release, we are extending for one year the date by which a foreign private issuer that is an accelerated filer (but not a large accelerated filer),[12] and that files its annual reports on Form 20-F or 40-F, must begin to comply with the requirement to provide the auditor's

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[9] Release No. 34-54295 (Aug. 9, 2006). In the companion proposing release, we request comment on the potential implications of separating management's report on internal control over financial reporting from the auditor's attestation report on internal control over financial reporting on the efficiency and effectiveness of implementation of the Section 404 requirements. We also request comment on a variety of other questions, including whether there is any relief or guidance that we should consider providing specifically with respect to foreign private issuers apart from the actions described in the release affecting foreign private issuers that are non-accelerated filers.

[10] Exchange Act Rule 12b-2(1) [17 CFR 240.12b-2(1)] defines an accelerated filer as an issuer that, among other criteria, has an aggregate market value of voting and non-voting common equity held by non-affiliates of the issuer of $75 million or more as of the last day of the issuer's most recently completed second fiscal quarter.

[11] Exchange Act Rule 12b-2(2) [17 CFR 240.12b-2(2)] defines a large accelerated filer as an issuer that, among other criteria, has an aggregate market value of voting and non-voting common equity held by non-affiliates of the issuer of $700 million or more as of the last day of the issuer's most recently completed second fiscal quarter.

[12] As defined in Rule 12b-2, the term "accelerated filer" does not include a filer that is a "large accelerated filer." The two categories of filers therefore are mutually exclusive.

attestation report on internal control over financial reporting.[13] Pursuant to this extension, this type of issuer must begin to comply with the requirement to provide the auditor's attestation report in the Form 20-F or 40-F annual report filed for its first fiscal year ending on or after July 15, 2007. The extension will become effective 30 days after this release is published in the Federal Register.

The extension that we are providing in this release does not alter any other requirements regarding internal control that already are in effect, including without limitation, Section 13(b)(2) of the Exchange Act[14] and the related rules, nor does it affect any other previously established compliance date. Therefore, a foreign private issuer that is an accelerated filer must begin to comply with the requirement to include management's report on internal control over financial reporting in the Form 20-F or 40-F annual report filed for its first fiscal year ending on or after July 15, 2006.

In the companion release referenced above that we also are issuing today, we are proposing that all non-accelerated filers, like the foreign private issuers that are the subject of this release, would include only management's report on internal control over financial reporting during their first year of compliance with the Section 404 requirements. In that release, we propose that during the first compliance year, the non-accelerated filer would "furnish" rather than file management's report. The release states that if we adopt that proposal, we intend to afford similar relief to the accelerated foreign private issuer filers that likewise will file only management's report during their first year of compliance with the Section 404 requirements.[15]

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[13] See Item 15(c) of 20-F and General Instruction B(6)(d) of Form 40-F.

[14] 15 U.S.C. 78m(b)(2).

[15] See Section II of Release No. 34-54295 (Aug. 9, 2006).

We invite foreign private issuers and all interested parties to comment on the questions raised in the companion release as to whether this type of proposed relief is appropriate.

The chief executive officer and chief financial officer of a foreign private issuer that is an accelerated filer must begin to provide the complete certification required by Exchange Act Rule 13a-14(a) or 15d-14(a),[16] including the references to the officers' responsibility for establishing and maintaining internal control over financial reporting in paragraph 4 of the certification, in the Form 20-F or 40-F annual report filed for the foreign private issuer's first fiscal year ending on or after July 15, 2006.

This extension also does not affect the date by which a foreign private issuer that is a large accelerated filer must comply with all of the internal control over financial reporting requirements.[17] These filers must include both a report by management and an attestation report by the issuer's registered public accounting firm on internal control over financial reporting, as well as complete certifications, in their Form 20-F or 40-F reports filed for a fiscal year ending on or after July 15, 2006. Our data indicates that out of the approximately 1,240 foreign private issuers that are subject to the Exchange Act reporting requirements, about 39% of these are large accelerated filers, 23% are accelerated filers, and the remaining 38% are non-accelerated filers.[18]

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[16] 17 CFR 240.13a-14(a) or 15d-14(a).

[17] We are not extending the compliance dates for large accelerated foreign private issuers given their more extensive reporting resources and the greater market interest they generate than smaller issuers. Industry sources indicate that these issuers are further along in their compliance efforts than the accelerated foreign private issuers and generally appear to be better prepared to comply with the current filing deadline. Furthermore, the distinction between large accelerated and accelerated foreign private issuers that we are making for purposes of the extension is consistent with a similar size-based distinction that we made in 2004 when we provided certain accelerated filers up to an additional 45 days to file their Section 404 reports. Although the order pre-dated our creation of the "large accelerated filer" category of issuers, companies with public equity float thresholds exceeding $700 million, representing approximately 96% of the U.S. equity market capitalization, were not eligible for the 45-day extension. See Release No. 34-50754 (Nov. 30, 2004).

[18] The estimated percentages of foreign private issuers within each accelerated filer category are based on market capitalization data from Datastream as of December 31, 2005.

The Commission, for good cause, finds that notice and solicitation of comment regarding extension of the audit attestation report compliance date for foreign private issuers that are accelerated filers (but not large accelerated filers) is impractical, unnecessary and contrary to the public interest for a variety of reasons.[19] One reason is that a number of events related to internal control assessments by companies and their auditors have occurred since we granted the last extension of compliance dates.

First, the extension will provide these foreign private issuers and their registered accounting firms an additional year to consider, and adapt to, any actions that the Commission and the Public Company Accounting Oversight Board decide to take as part of their plans announced on May 17, 2006 to improve the implementation of the Section 404 requirements.[20]

These actions include:

- Revisions to Auditing Standard No. 2;
- Issuance of a Concept Release soliciting comment on a variety of issues that might be included in future Commission guidance for management to assist in its performance of a top-down, risk-based assessment of internal control over financial reporting;
- Reinforcement of auditor efficiency through PCAOB inspections;

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[19] See Section 553(b)(3)(B) of the Administrative Procedure Act [5 U.S.C. 553(b)(3)(B)] (stating that an agency may dispense with prior notice and comment when it finds, for good cause, that notice and comment are "impracticable, unnecessary, or contrary to the public interest."). Also, because the Regulatory Flexibility Act [5 U.S.C. 601-612] only requires agencies to prepare analyses when the Administrative Procedures Act requires general notice of rulemaking, that Act does not apply to the actions that we are taking in this release.

[20] See SEC Press Release 2006-75 (May 17, 2006), "SEC Announces Next Steps for Sarbanes-Oxley Implementation" at http://www.sec.gov/news/press/2006/2006-75.htm and PCAOB News Release entitled "Board Announces Four-Point Plan to Improve Implementation of Internal Control Reporting Requirements" at http://www.pcaobus.org/News_and_Events/News/2006/05-17aspx.

- Development, or facilitation of development, of implementation guidance for auditors of smaller public companies; and
- Continuation of PCAOB forums on auditing in the small business environment.

Although the first three initiatives will affect all Exchange Act reporting companies subject to the Section 404 internal control requirements, including accelerated and large accelerated domestic filers and their registered public accounting firms that already have been complying with these requirements for two years, as well as large accelerated foreign private issuers and their auditors, we expect that smaller foreign private issuers likely will face greater challenges than these larger filers as they prepare to comply with the internal control reporting requirements.

Second, on April 23, 2006, the SEC's Advisory Committee on Smaller Public Companies submitted its final report to the Commission.[21] The final report includes recommendations designed to address the potential impact of the internal control reporting requirements on smaller public companies. Specifically, the Advisory Committee recommends that certain smaller public companies be exempted from the management report requirement and from external auditor involvement in the Section 404 process under certain circumstances unless and until a framework for assessing internal control over financial reporting is developed that recognizes the characteristics and needs of these companies.

Third, on May 10, 2006, the Commission and PCAOB sponsored a roundtable to elicit feedback from companies, their auditors, board members, investors, and others regarding their experiences during the accelerated filers' second year of compliance with the internal control

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[21] See Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission (April 23, 2006), available at http://www.sec.gov/info/smallbus/acspc.shtml.

over financial reporting requirements. Several of the comments provided at, and in connection with, the roundtable expressed support for revisions to the PCAOB's Auditing Standard No. 2.[22]

Apart from these developments, solicitation of public comment regarding extension of the compliance date is impractical given that the current compliance date requires management of foreign private issuers that are accelerated filers to assess internal control over financial reporting at the end of the first fiscal year ending on or after July 15, 2006. We anticipate that these issuers and their investors would be unlikely to derive any meaningful benefit from an extension that is granted several months from now as the issuers' registered public accounting firms likely would have completed substantial work on their internal control audits by then, and the issuers would have incurred fees for the work already completed by the auditor. We recognize that some of the foreign private issuers qualifying for this extension may already be at such an advanced stage of preparation for compliance with the internal control reporting requirements, including the audit report requirement, that they may choose to include both the management and audit report in the annual report they file for their first fiscal year ending on or after July 15, 2006.

Another reason for the extension is that it will enable management of these foreign private issuers to begin the process of reviewing and evaluating the effectiveness of internal control over financial reporting a year before the initial audit of such effectiveness but will still permit investors to begin to see and evaluate the results of these initial efforts. Management will not have to devote time and resources to assisting the auditor with its audit of internal control over financial reporting and can use the first year of compliance as an opportunity to more

22 See, for example, letters from the Biotech Industry Association, American Electronics Association, Emerson Electric Institute, U.S. Chamber of Commerce and Joseph A. Grundfest. These letters are available in File No. 4-511, at http://www.sec.gov/news/press/4-511.shtml.

gradually prepare for compliance with the audit portion of the requirements in the second year. We believe that this will reduce the first year cost of compliance. The extension also should enable foreign private issuers that are accelerated filers to benefit from the learning and efficiencies gained by the auditing firms as a result of their previous experience auditing the large accelerated foreign private issuers' compliance with the Section 404 requirements.

While acknowledging the potential risks that could stem from a lack of required auditor involvement in the first year of the internal control assessment process, a more gradual transition to full compliance ultimately should make implementation of the internal control over financial reporting requirements more effective. Consequently, this will benefit investors and improve confidence in the reliability of the disclosure made by these companies about their internal control over financial reporting.

As a result of the extension, these foreign private issuers will not have to incur the cost of the internal control audit during the first compliance year. Furthermore, we have learned from public comments, including our roundtables on implementation of the internal control reporting provisions,[23] that while many companies incur increased internal costs in the first year of compliance due to "deferred maintenance" items (e.g., documentation, remediation, etc.), these costs may decrease in the second year. Therefore, postponing the audit costs until the second year would help smooth the significant cost spike that has been experienced by many accelerated filers in their first year of compliance. A competitive or cost impact could result from the differing treatment of accelerated foreign private issuers that are the subject of the actions that

[23] Materials related to the Commission's 2005 Roundtable Discussion on Implementation of Internal Control Reporting Provisions and 2006 Roundtable on Second-year Experiences with Internal Control Reporting and Auditing Provisions, including the archived roundtable broadcasts, are available at http://www.sec.gov/spotlight/soxcomp.htm.

we are taking today and large accelerated foreign private issuers that are not affected by these actions.

Finally, four commenters on the Commission's pending proposals regarding termination of a foreign private issuer's registration of a class of securities under Exchange Act Section 12(g) and duty to file periodic reports[24] requested that the Commission extend the compliance dates for the Section 404 requirements. The extension of compliance dates announced in this release will provide foreign private issuers (other than large accelerated filers) with the opportunity to determine whether they meet any revised deregistration criteria that the Commission determines to adopt before having to implement steps toward providing an auditor attestation report on internal control over financial reporting.[25] We have been considering all of the public comments on the deregistration proposals and expect to take further action on them by early fall of this year.

Statutory Authority and Text of the Rule Amendments

We are adopting the amendments described in this release pursuant to Sections 12, 13, 15 and 23 of the Exchange Act.

List of Subjects

17 CFR Part 210

Accountants, Accounting, Reporting and recordkeeping requirements, Securities.

17 CFR Part 249

Reporting and recordkeeping requirements, Securities.

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[24] Rel. No. 34-53020 (Dec. 23, 2005) [70 FR 77688].

[25] See Letters from the American Bar Association, Section of Business Law, Committee on Federal Regulation of Securities at pp. 6-7, Cleary Gottlieb Steen & Hamilton LLP at p. 19, the European Association for Listed Companies and 16 other European industry association signatories at p.6 and the European Commission at p. 10, at http://www.sec.gov/rules/proposal/s71205.shtml.

TEXT OF AMENDMENTS

For the reasons set forth above, we are amending title 17, chapter II, of the Code of Federal Regulations as follows:

PART 210 - FORM AND CONTENT OF AND REQUIREMENTS FOR FINANCIAL STATEMENTS, SECURITIES ACT OF 1933, SECURITIES EXCHANGE ACT OF 1934, PUBLIC UTILITY HOLDING COMPANY ACT OF 1935, INVESTMENT COMPANY ACT OF 1940, INVESTMENT ADVISERS ACT OF 1940, AND ENERGY POLICY AND CONSERVATION ACT OF 1975

1. The authority citation for Part 210 continues to read, in part, as follows:

Authority: 15 U.S.C. 77f, 77g, 77h, 77j, 77s, 77z-2, 77z-3, 77aa(25), 77aa(26), 78c, 78j-1, 78l, 78m, 78n, 78o(d), 78q, 78u-5, 78w(a), 78ll, 78mm, 79e(b), 79k(a), 79n, 79t(a), 80a-8, 80a-20, 80a-29, 80a-30, 80a-31, 80a-37(a), 80b-3, 80b-11, 7202 and 7262, unless otherwise noted.

2. Section 210.2-02T is added after Section 210.2-02 to read as follows:

§210.2-02T Accountants' reports and attestation reports on management's assessment of internal control over financial reporting.

(a) The requirements of Section 210.2-02(f) shall not apply to a registered public accounting firm that issues or prepares an accountant's report that is included in an annual report on Form 20-F or 40-F (§249.220f or 249.240f of this chapter) filed by a foreign private issuer that is an accelerated filer, as that term is defined in §240.12b-2 of this chapter, for a fiscal year ending on or after July 15, 2006 but before July 15, 2007.

(b) This temporary section will expire on December 31, 2007.

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PART 249 – FORMS, SECURITIES EXCHANGE ACT OF 1934

3. The authority citation for Part 249 continues to read, in part, as follows:

Authority: 15 U.S.C. 78a et seq. and 7201 et seq.; and 18 U.S.C. 1350, unless otherwise noted.

*   *   *   *   *

4. Form 20-F (referenced in §249.220f), Part II, is amended by adding Item 15T after Item 15 to read as follows.

Note: The text of Form 20-F does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM 20-F

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PART II

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Item 15T. Controls and Procedures.

Note to Item 15T: This is a special temporary section that applies instead of Item 15 only to an issuer that is an "accelerated filer," but not a "large accelerated filer," as those terms are defined in §240.12b-2 of this chapter, and only with respect to an annual report that the issuer is required to file for a fiscal year ending on or after July 15, 2006 but before July 15, 2007.

(a) Disclosure Controls and Procedures. Where the Form is being used as an annual report filed under section 13(a) or 15(d) of the Exchange Act, disclose the conclusions of the issuer's principal executive and principal financial officers, or persons performing similar functions, regarding the effectiveness of the issuer's disclosure controls and procedures (as defined in 17 CFR 240.13a-15(e) or 240.15d-15(e)) as of the end of the period covered by the report, based on the evaluation of these controls and procedures required by paragraph (b) of 17 CFR 240.13a-15 or 240.15d-15.

(b) Management's annual report on internal control over financial reporting. Where the Form is being used as an annual report filed under section 13(a) or 15(d) of the Exchange Act, provide a report of management on the issuer's internal control over financial reporting (as defined in §240.13a-15(f) or 240.15d-15(f) of this chapter). The report must contain:

(1) A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the issuer;

(2) A statement identifying the framework used by management to evaluate the effectiveness of the issuer's internal control over financial reporting as required by paragraph (c) of §240.13a-15 or 240.15d-15 of this chapter; and

(3) Management's assessment of the effectiveness of the issuer's internal control over financial reporting as of the end of the issuer's most recent fiscal year, including a statement as to whether or not internal control over financial reporting is effective. This discussion must include disclosure of any material weakness in the issuer's internal control over financial reporting identified by management. Management is not permitted to conclude that the issuer's internal control over financial reporting is effective if there are one or more material weaknesses in the issuer's internal control over financial reporting.

(c) Changes in internal control over financial reporting. Disclose any change in the issuer's internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of §240.13a-15 or 240.15d-15 of this chapter that occurred during the period covered by the annual report that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.

Instruction to Item 15T

The registrant must maintain evidential matter, including documentation to provide reasonable support for management's assessment of the effectiveness of the issuer's internal control over financial reporting.

(d) This temporary Item 15T, and accompanying note and instructions, will expire on December 31, 2007.

* * * * *

5. Form 40-F (referenced in §249.240f) is amended by revising "Instruction to paragraphs (b), (c), (d) and (e) of General Instruction B.(6)" as follows:

a. adding an "s" to the word "Instruction" in the descriptive heading of the Instructions to paragraphs (b), (c), (d) and (e) of General Instruction B(6).

b. adding Instruction 2T.

The addition reads as follows:

Note: The text of Form 40-F does not, and this amendment will not, appear in the Code of Federal Regulations.

FORM 40-F

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GENERAL INSTRUCTIONS

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B. Information To Be Filed on this Form

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(6) * * *

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2T. Paragraph (d) of this General Instruction B.6 does not apply to an issuer that is an "accelerated filer," but not a "large accelerated filer," as those terms are defined in Rule 12b-2 of this chapter, with respect to an annual report that the issuer is required to file for a fiscal year ending on or after July 15, 2006 but before July 15, 2007.

This temporary Instruction 2T will expire on December 31, 2007.

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By the Commission.

Nancy M. Morris
Secretary

August 9, 2006

FINANCIAL REPORTING/CORPORATE GOVERNANCE

What do they say about your company?

Management Reports on Internal Controls

BY DAVID M. WILLIS AND SUSAN S. LIGHTLE

EXECUTIVE SUMMARY

- **PUBLIC COMPANIES INCREASINGLY INCLUDE** management reports on internal controls in their annual reports even though no regulators require them.
- **SINCE ACCOUNTANTS AND AUDITORS ARE DIRECTLY** involved in auditing financial statements and reviewing internal controls, they are in a good position to suggest what degree of reporting is appropriate.
- **MANAGEMENT REPORTS ON INTERNAL CONTROLS** provide a unique opportunity for management to discuss issues and concerns not communicated elsewhere in the annual report.
- **SINCE THESE REPORTS FIRST STARTED APPEARING,** there is a growing consensus as to what the contents should include: financial statement presentation; purpose, nature and components of internal controls; and the roles of internal audit, the independent auditor and the audit committee. Also, unique programs can be emphasized.
- **COMPANIES ARE CAREFUL TO POINT OUT** the inherent limitations of internal controls. A significant number of the companies studied acknowledge that "the systems are

designed to provide only a reasonable assurance of meeting stated objectives."

- **IF INDEPENDENT ATTESTATION OF MANAGEMENT** reports were required, such a mandate would have a significant impact on the roles of both the independent auditor and management. Unless specifically engaged to evaluate a company's internal control system, the auditor typically is not giving an opinion on the adequacy of the controls.

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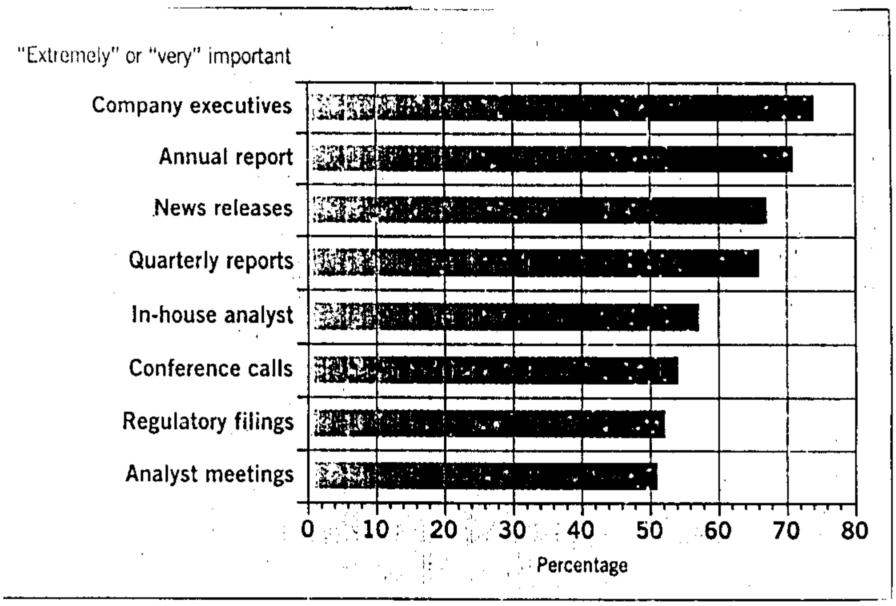
Turn to page xx of a publicly traded company's annual report. If there's a section where management discusses its internal controls, that company has found a venue to communicate with its shareholders—current and potential—about the strategies and policies it has adopted to ensure that the company is "under control." Public companies increasingly include management reports on internal controls in their annual reports as a good corporate governance practice. At least for now, management has considerable latitude in deciding what it wishes to address in these reports.

Should management be required to report on internal controls, and should independent auditors have to attest to such reports? Although neither the SEC nor FASB require them, these reports have existed for more than a decade; the debate on their mandatory inclusion has been waged for more than 20 years. There are, of course, varying opinions as to whether the needs of financial statement users are being met by existing reporting requirements. Since accountants and auditors are the professionals directly involved in auditing financial statements and reviewing internal controls, they may be in the best position to suggest what degree of reporting is appropriate.

Importance of Information Sources

In a global survey released earlier this year, 69% of investment professionals said the overall quality of financial information disclosed by most publicly traded companies had improved. Nearly three out of four respondents pointed to executive interviews as key sources of information, followed by annual reports and financial news releases.



Source: Corporate Disclosure Survey, Association for Investment Management and Research, Charlottesville, Virginia, www.aimr.org/standards.

According to the 1999 edition of *Accounting Trends and Techniques*, approximately 58% of public companies included management reports in their 10K. This is the one place in an annual report where management can focus readers' attention on issues not systematically discussed elsewhere. A content analysis can help both the writers and users of the reports, as well as the outside auditors, in determining what specific items warrant inclusion.

The content of the reports varies considerably. While the focus in general is on the effectiveness of internal controls, the specific components of internal control are by no means consistent across companies. The differences noted in the reports may reflect the variations in how companies structure their internal control systems or they may reflect the differences in the companies' reporting philosophies.

Since the reports first started appearing about 10 years ago, preparers have reached agreement on some of the routine items to be included, and now discuss the features of their overall control systems that are unique or of special significance.

Management reports typically discuss the following topics:

- Financial statement presentation.
- The purpose, nature and components of the company's internal controls.
- The role of internal audit.
- The role of the audit committee.
- The role of the independent auditor.

FINANCIAL STATEMENT PRESENTATION

An analysis of the annual reports of the 1998 Fortune 100 revealed 78 companies had included management reports, virtually all of which began with a statement that management took responsibility for the presentation of the reports in this study of the financial statements. Ninety-seven percent said the financial statements conformed to GAAP and 15% said the financial statements represented fairly the company's financial position and results of operations (see exhibit 1).

PURPOSE AND NATURE OF INTERNAL CONTROLS

All but 2 of the 78 companies said they maintained a system of internal control. Most noted the purpose of that system: 87% identified reliable financial reporting and 81%, safeguarding of assets (see exhibit 2). Just over half of the reports—54%—said the objective was encouraging adherence to management's prescribed policies and procedures, while 51% linked internal controls and ethical conduct. A few of the reports specifically cited the objective of preventing or detecting fraudulent financial reporting. One company, General Electric, identified a sound, dynamic system of internal controls as "a vital ingredient" for the company's quality programs.

Several reports identified specific components of their internal control structures (see exhibit 3). The most frequently cited was the existence of an internal audit function (78%), followed by the maintenance of policies and procedures (63%), the selection and training of good personnel (43%) and segregation of duties (42%). Also mentioned were continuous review and revision of internal controls and a strong control environment or ethical climate. Almost half of the reports referred to a company code of conduct or ethics policy. Several of the reports noted that the policy addressed such elements as conflict of interest, compliance with applicable laws and confidentiality concerns.

Improve Business Reporting by Evaluating Internal Controls

The report, *Internal Control—Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in 1992, did not give an opinion on whether internal control reports by management and independent attestation of them should be required. However, the report did indicate that company management should continuously and periodically evaluate the effectiveness of its internal controls. In 1994, the AICPA examined the information needs of professional investors and creditors and their advisers, and noted, "Although users are not enthusiastic about expanding the scope of audits, one exception relates to internal control. They believe that business reporting would benefit from increased auditor involvement in internal accounting controls" (from *Improving Business Reporting—A Customer Focus: Meeting the Information Needs of Investors and Creditors,* page 105. For other information, see "Letter From the Chairman of the AICPA Special Committee on Financial Reporting," *JofA*, Oct.94, page 39).

Seven reports referred to a review process for assuring compliance with ethical standards. For example, an important part of International Paper Co.'s internal controls system was its ethics program and long-standing policy on ethical business conduct, including a telephone "compliance line" to report suspected violations of law or company policy and its newly established office of ethics and business practices. To ensure that personnel continued to understand the internal control system and policies governing prudent business practices, Merck said it had an ongoing "management stewardship program" for key management and financial personnel and had implemented an ethical business practices program to reinforce its commitment to high ethical standards in conducting its business. CIGNA provided each employee with a copy of the corporate policy addressing business ethics and required that all officers, directors and certain other employees sign the policy statement annually. These statements suggest myriad ways in which corporate managements are seeking to share with outsiders their companies' commitment to ethical principles.

POINT OUT LIMITATIONS

Companies also were careful to point out the inherent limitations of internal controls. Eighty-six percent of the reports acknowledged the systems' designs provided only "reasonable assurance" of meeting stated objectives. Thirty-five percent said the internal controls' cost should not exceed anticipated benefits. Sears, for example, explained that the "concept of reasonable assurance is based on the premise that the cost of internal controls should not exceed the benefits derived."

A number of reports spelled out the limitations. One of the most extensive clarifications came from Enron: "It should be recognized, however, that there are inherent limitations in the effectiveness of any system of internal control. Accordingly, even an effective internal control system can provide only reasonable assurance with respect to the preparation of financial statements and safeguarding of assets. Further, because of changes in conditions, internal control system effectiveness may vary over time."

In spite of these limitations, managements often tried to assure statement readers of the soundness of their internal controls. Although about half of the companies in the study asserted specifically that their internal controls were effective or strong, they did not address the basis for this assessment. Only three of the *Fortune 100*—Freddie Mac, Halliburton and Ameritech—said their assessments were based on recognized criteria for internal control, with Ameritech the only one specifically listing the five components of internal control defined by the *COSO Internal Control Integrated Framework:*

- Control environment.
- Risk assessment.
- Control activities.
- Information and communication.
- Monitoring.

INTERNAL AUDIT'S ROLE

The most frequently cited functions of the internal audit department were monitoring compliance with the internal control structure and assessing its effectiveness. Seventeen percent noted internal audit provides recommendations to improve controls and correct deficiencies. One company, Procter & Gamble, pointed out its use of a self-assessment program to help "individual organizations…evaluate the effectiveness of their controls" and suggested this program supplemented the internal audit function.

Jack Dierkes, assistant director of the company's internal audit unit, offered this perspective: "P&G believes that controls are the responsibility of the line organization. One role of internal auditing is to audit the line organization, identify gaps and ensure the appropriate action plans are put in place. Since our audit cycle is about three years, we find it helpful to supplement the audits with self-assessments [which] are led by the line organization and conducted about once a year. The internal controls group is available as needed to help the line organization conduct an effective self-assessment. Ideally, problems are identified and fixed before internal auditing conducts official audits."

Most of the reports did not define the reporting structure of the internal audit department, although Merrill Lynch said its corporate audit department reported directly to the audit and finance committee of the board of directors; P&G noted that internal audit ultimately reported to the CFO, and two organizations, Fannie-Mae and General Electric, said internal audit was organizationally independent of the activities it reviewed.

Why Include a Report of Management in the Annual Report?

According to Ameritech's general auditor, Bruce Adamec, "the principal reason for including the management report on controls in [our] annual report is to inform investors about the roles management and the Board Audit Committee play in the financial reporting process."

"Management and the board believe it is paramount that we acknowledge that the financial statements are the company's and that top management explicitly takes responsibility for the company's financial reporting process and its system of internal controls. Additionally, an important disclosure is the extent to which management assures itself and the board that the controls are effective."

Adamec sees the report of management as a signal to investors that management and the board place a high priority on internal controls. He also points out that the report communicates the same message to employees, helping to set the appropriate "tone at the top," in the terminology of *Report of the National Commission on Fraudulent Financial Reporting* (the Treadway report). He further notes that the management report has had a positive impact on the audit committee and management itself. "Signing the report has given top management and the board audit committee a heightened awareness and interest in performing their internal control responsibilities."

THE AUDIT COMMITTEE'S ROLE

Seventy-four (95%) of the reports referred to an audit committee. Of these, 92% said its members were independent or not part of management and that the audit committee regularly met with the independent auditor (81%), the internal audit director (78%) and management (76%) (see exhibit 4). Of the seventy-four companies, in 69% the independent auditor had full and free access to the audit committee and in 60% the internal audit director had the same access. It is not surprising that many management reports addressed the role of audit committees in light of work of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (see "Blue-Ribbon Panel Issues Its 10 Commandments," *JofA*, Apr.99, page 4). Incidentally, of the reports reviewed in this study, none referred to all the committee's recommendations, and the nature and extent of the information provided varies. (See "Audit Committee Rules to Improve Disclosure," *JofA* Apr.00, page 15.)

Management reports identified the following responsibilities of the audit committee; the percentages in parentheses refer to the portion of the 74 companies with an audit committee.

- Oversight of financial reporting process (78%).
- Review of internal controls (81%).
- Review the scope and results of internal and independent audits performed (69%).
- Oversight of the internal and independent audit functions (27%).
- Make recommendations concerning the selection of the independent auditor (26%).
- Oversight of management (20%).

Two reports (those of Merrill Lynch and J.C. Penney) said the audit committee had responsibility for compliance with acceptable business standards and ethics; J.C. Penney's reviewed audit *and nonaudit* services and fees. Ameritech said its audit committee was responsible for "assuring the independence" of the independent auditor. A few reports in exhibit 4 discussed the size of the committee and frequency of its meetings.

Seven Effective Uses of Management Reports

Including management reports in the company's annual report is one of the steps public companies have taken to improve corporate and financial disclosure to their shareholders and interested third parties. There are good reasons to use these reports:

- **Communicate how your company provides an effective system of internal controls.**
- **Discuss how your company uses internal controls to**

help protect its resources and reach its strategic goals. Identify the components of internal controls that are especially important to you, and reassure the users of the report that your system of controls is working.

- Point out the ways internal audit assures overall goals and objectives are being met.
- Clarify the audit committee's role. Use the report to emphasize its enhanced functions.
- Explain how your company uses its independent auditors to help manage or assess its control systems.
- Take advantage of the location of the management report in the annual report to explain how your company's practices compare with other leading companies in industry.
- Highlight what's unique about your company. For example, if you've adopted a code of ethical conduct for your employees, advertise that here.

WHAT THE INDEPENDENT AUDITOR DOES

Most of the management reports (85%) referred to the independent audit of the company, with 44% referring to the audit report in the annual report (see exhibit 5, page 64). Several (40%) said the audit was conducted in accordance with GAAS, including appropriate tests of accounting procedures and records. A few noted that all financial records and minutes were made available to the independent auditor or that the representations made to the independent auditor were valid.

Half of the reports said the independent auditor had included some consideration of internal controls. The wording used to describe the nature of this consideration varied. Most common was the term *review* of internal controls, followed closely by *evaluation or assessment of, consideration of,* and *obtaining an understanding of.* Also used were *study, testing* and *examination* of internal controls. Only half of the reports referring to the external auditor's consideration of internal controls explained that the purpose of such consideration was to assist in the design of the audit and not to provide support for an opinion on the adequacy of controls.

DRAWING DISTINCTIONS

If independent attestation of management reports were required, such a mandate would have a significant impact on the roles of both the independent auditor and management in this process. In traditional auditing and attestation services, the profession draws a sharp line between an "audit" and a "review." Specific standards guide the practitioner in providing these differentiated services. Perhaps equally critically, the audit and review reports themselves attempt to clarify for the readers the nature and extent of the work performed.

The management reports usually do not make similar distinctions. A statement in a management report that the independent auditor has "considered" "reviewed" or "examined" the company's internal controls unintentionally might cause a reader to infer that the auditor has indicated the internal control system is working effectively. In most cases, such an inference would be misleading since the auditor was not engaged to express an opinion on the adequacy of the controls. Unless specifically engaged to assess or evaluate a company's internal control system, independent auditors examine internal controls only for the purpose of designing their overall audit tests of the financial records. Beyond that, no testing of internal controls is required. For this reason the language that is used may merit closer scrutiny.

Auditing standards require that the auditor read other information in a document which may be relevant to the audit or to the propriety of the report. SAS no. 8, *Other Information in Documents Containing Audited Financial Statements,* cautions the auditor to discuss the information with the client if he or she becomes aware that such information conflicts with his or her knowledge of such matters, or if a material misstatement of fact exists, the auditor should consider notifying the client in writing of his or her views concerning the information and consulting legal counsel.

Since management reports are typically included in companies' annual reports, which contain audited financial statements, the auditor is required to read them. "In reading such information, the auditor should evaluate specific references by management that deal with the auditor's consideration of internal controls in planning and performing the audit of the financial statements, particularly if such reference would lead the reader to assume that the auditor had performed more work than required under generally accepted accounting standards or would lead the reader to believe the auditor was giving assurances on internal control" (from AICPA, *Professional Standards,* AU section 9550.14, *Other Information in Documents Containing Audited Financial Statements: Auditing Interpretations of Section 550*).

The findings of this study indicated that the word most commonly used to describe the nature of the auditor's consideration of the company's internal controls was "reviewed." Because "a statement by management that the auditors had 'reviewed' the company's internal controls would be inappropriate," (see footnote to AU section 9550.14), auditors may need to more closely scrutinize clients' management reports to comply with the standard's guidance (see exhibit 5).

The profession should consider the results of this study in the debate on whether to mandate management reports of publicly traded companies and, if so, what those reports should include. Management reports can be another vehicle to improve corporate governance structures. The strength of the management report is the unique opportunity it affords management to address in a focused part of its annual report those concerns it believes are especially important for its company. The report becomes a vehicle for defining management's control strategy, for explaining how its practices compare with those of other companies, and for highlighting where its efforts may represent cutting-edge attempts to make its company more profitable and efficient. Companies with innovative programs can use these reports to emphasize how important these initiatives are.

2000 AICPA

Exhibit 1: Management's Discussion of Financial Statements

Percentage of companies that included these elements in management reports:

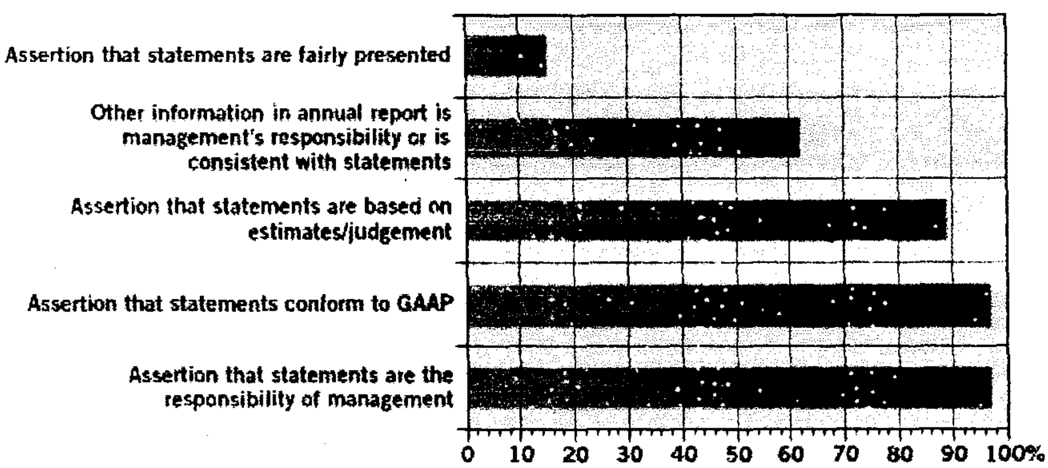


Exhibit 2: Purpose of Internal Controls

Percentage of companies that reported they

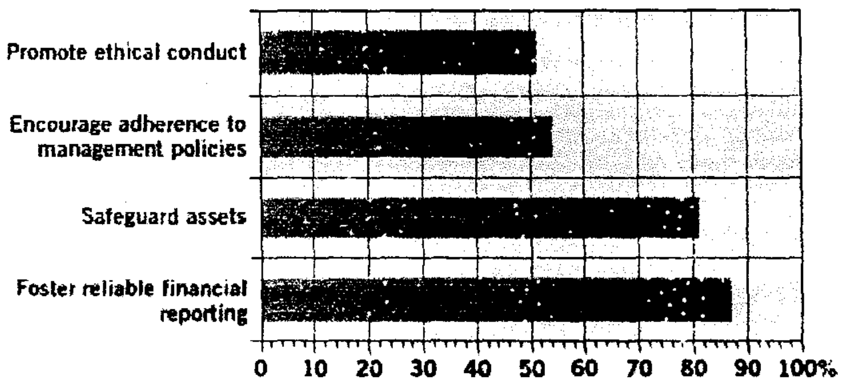


Exhibit 3: Components of Internal Control

Percentage of companies that have

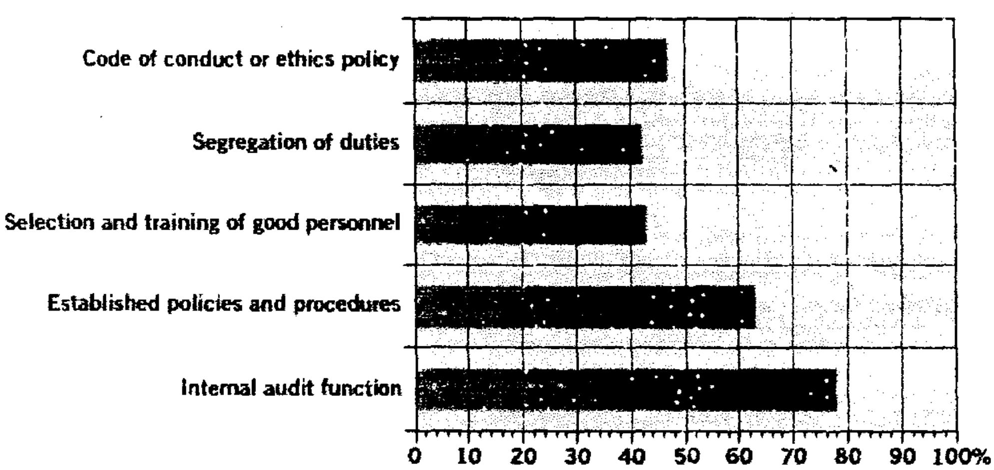


Exhibit 4: Role of Audit Committee

Percentage of companies that reported

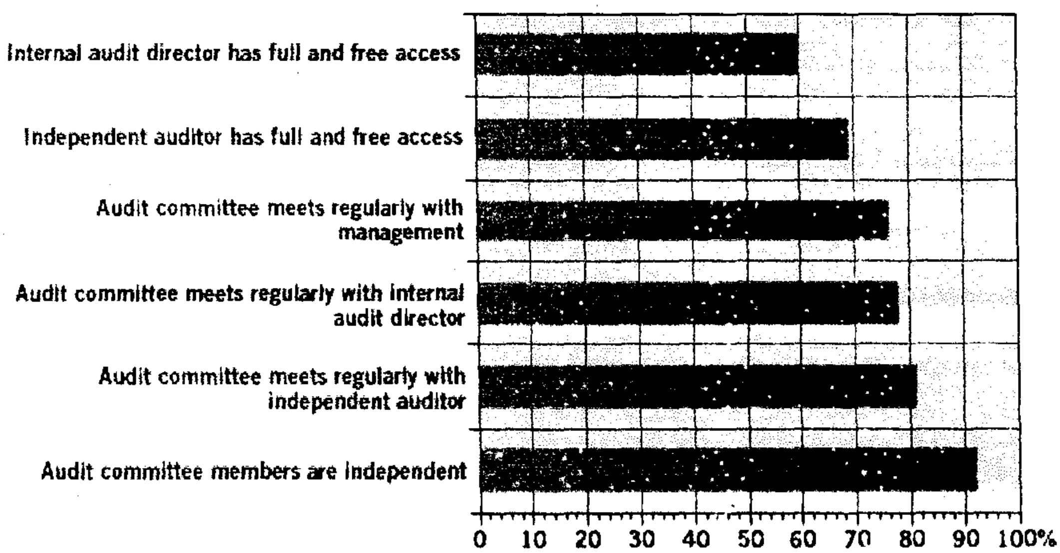


Exhibit 5: Role of Independent Audit

Percentage of companies whose management reports