

Client Alert

SEC Adopts Final Rules Requiring Management Report on Internal Control Over Financial Reporting

A. Introduction

Implementing § 404 of the Sarbanes-Oxley Act of 2002 (“SOA”), the SEC released final rules on June 5, 2003 that will require public companies to include in their annual reports filed with the SEC an internal control report stating management’s responsibility for establishing and maintaining adequate internal control over financial reporting and containing management’s assessment of the effectiveness of this internal control.¹ The company’s auditor must also attest to, and report on, management’s assessment. In addition to the annual internal control report, the new rules require management to evaluate and disclose any changes in the company’s internal control over financial reporting on a quarterly basis.

The final rules also modify the form of the § 302 officer certification in several respects, and require issuers to provide the § 302 and § 906 officer certifications as exhibits to the periodic reports to which they relate.

Companies that are “accelerated filers” must include the internal control report in their annual reports filed for fiscal years ending after June 15, 2004, and will be required to disclose any material changes in the company’s internal control beginning with quarterly reports due thereafter.² Early voluntary compliance is permitted. The modifications to the form of the § 302 certification, as well as the requirement to file § 302 and § 906 certifications as exhibits, generally become effective for periodic

¹ Securities and Exchange Commission Release Nos. 33-8238; 34-47986; IC-26068; File Nos. S7-40-02; S7-06-03. A copy of the release is available on the SEC website at <http://www.sec.gov/rules/final/33-8238.htm>.

² “Accelerated filers” are generally U.S. reporting companies that have an equity market capitalization of over \$75 million, that have been subject to Exchange Act reporting requirements for at least one year and that have previously filed an annual report with the SEC. Companies that are not “accelerated filers” (including foreign private issuers) must comply beginning with annual reports filed for fiscal years ending after April 15, 2005.

reports due on or after August 14, 2003 (subject to an extended compliance period for certain internal control matters as discussed below). Many companies will need to comply with the certification requirements in their quarterly reports on Form 10-Q for the quarter ended June 30, 2003.

B. Annual Internal Control Report

The final rules require a company's annual report to include an internal control report of management, which shall contain:

- a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting;
- a statement identifying the framework used by management to evaluate the effectiveness of the internal control over financial reporting;
- management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including a statement as to whether or not the company's internal control over financial reporting is effective and identifying any "material weaknesses";³ and
- a statement that the company's independent auditor that audited the financial statements included in the annual report has issued an attestation on management's assessment, a copy of which shall be filed as part of the company's annual report.

While the final rules do not specify where management's internal control report must appear in the company's annual report, the SEC notes that it is important for the report to be in close proximity to the corresponding auditor attestation report and expects that many companies will choose to place the internal control and attestation reports either near its MD&A disclosure or immediately preceding the financial statements.

"Internal Control Over Financial Reporting". The final rules define "internal control over financial reporting" as a process designed by, or under the supervision of, the CEO and CFO, or persons performing similar functions, and effected by the company's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of

³ The SEC has stated that a negative statement indicating that nothing has come to management's attention to suggest that the internal control is not effective is not acceptable.

financial statements for external purposes in accordance with GAAP, including policies and procedures that:

- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures of the company are being made only in accordance with authorization of management and directors of the company; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.

This definition was derived in part from the financial reporting aspects of internal controls addressed in a report published in 1992 by the Committee of Sponsoring Organizations ("COSO") of the National Commission on Fraudulent Reporting, also known as the Treadway Commission.

Evaluation of Effectiveness of Internal Control. The final rules do not set forth specific criteria for management's evaluation of the effectiveness of its internal control over financial reporting, but instead require management to base its evaluation on "a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including broad distribution of the framework for public comment". In its release, the SEC cited the internal control framework in the 1992 COSO report as an acceptable framework, although the SEC noted that other suitable frameworks do exist outside the U.S. and may develop over time in the U.S.

The SEC noted that a suitable internal control framework must:

- be free from bias;
- permit reasonably consistent qualitative and quantitative measurement of a company's internal control;
- be sufficiently complete so that those relevant factors that would alter a conclusion about the effectiveness of a company's internal control are not omitted; and
- be relevant to an evaluation of internal control over financial reporting.

Recognizing that the methods of conducting evaluations of internal control over financial reporting will vary from company to company, the SEC did not specify the

methods or procedures to be performed in such an evaluation. The SEC notes, however, that the company's assessment must be based on procedures sufficient both to evaluate its design and to test its operating effectiveness. In addition, the SEC states that companies 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.

“Material Weaknesses” in Internal Control. The final rules require management to disclose in its annual internal control report any “material weaknesses” in the company's internal control over financial reporting. For purposes of the rules, “material weakness” is defined by reference to generally accepted auditing standards and attestation standards. Management is not permitted to conclude that a company's internal control over financial reporting is effective if it identifies one or more “material weaknesses” in such control.

Auditor Attestation to Internal Control Report. As stated above, the internal control report must be attested to by the independent auditor that audited the financial statements of the company included in the annual report and such attestation must be filed with the annual report. Section 404 of SOA requires the Public Company Accounting Oversight Board (“PCAOB”) to set standards for auditor attestations on management's internal control reports. In April 2003, the PCAOB designated the existing Statements on Standards for Attestation Engagements No. 10 as the standard applicable on a transition basis for § 404 attestations, pending further PCAOB standard setting. The SEC expects that the PCAOB will assess the appropriateness of these standards and modify them as needed.

C. Quarterly Evaluation of Material Changes

Under the final rules, an issuer's management (including the CEO and CFO) must evaluate any change in the company's internal control over financial reporting occurring during each fiscal quarter that has materially affected, or is reasonably likely to have a material effect on, the company's internal control over financial reporting and report any such changes in the company's annual and quarterly reports.

D. Section 302 and 906 Officer Certifications

Amendments to § 302 Certification. The final rules adopt a number of changes to the form of certification required by § 302 of SOA. Several of the changes relate to the new § 404 rules discussed above and require the CEO and CFO to certify as to the establishment, maintenance and design of the issuer's internal control over financial

reporting. Other modifications include the requirement that the officers' evaluation of the effectiveness of an issuer's disclosure controls and procedures be as of the end of the period covered by the report, instead of a date within 90 days prior to filing the report as currently required. The new form of § 302 certification is generally effective for periodic reports due on or after August 14, 2003. The portions of the certification relating to the establishment, maintenance and design of internal control will not, however, become effective until the annual internal control report requirements discussed above become effective.

Exhibit Requirement. Under the final rules, the certifications required under § 302 and § 906 of the SOA must be included as exhibits to the periodic reports to which they relate. This change is intended to make the certifications easier to access via the SEC's EDGAR system. Because § 906 of SOA requires that the certification "accompany" the periodic report to which it relates (as opposed to the § 302 certification, which is required to be included "in" the periodic report), the final rules permit companies to "furnish", rather than "file", the § 906 certification as an exhibit with the SEC. As a result, § 906 certifications will not be subject to liability under § 18 of the Exchange Act or to automatic incorporation by reference in a company's registration statements under the Securities Act of 1933. The § 302 and § 906 certifications must be filed as exhibits beginning with periodic reports due on or after August 14, 2003.

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For Additional Information

This client alert can be found, together with other recent Chadbourne & Parke LLP client alerts, at http://www.chadbourne.com/publications/sub_Publications.html. If you have any questions regarding the SEC's rules on internal control reports and officer certifications, please contact any of the following:

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