



FENWICK & WEST LLP

CORPORATE & SECURITIES LAW UPDATE

SEC Final Rule: Internal Control Reports, Attestations and Certifications

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SEC Final Rule: Internal Control Reports, Attestations and Certifications

On June 5, 2003 the SEC adopted rules implementing Section 404 of the Sarbanes-Oxley Act, which requires management of reporting companies to evaluate and report on internal controls, and outside auditors to attest to these evaluations. Recognizing the substantial effort that will be needed for companies to comply with this mandate, the SEC moved back the compliance dates for these reports—to fiscal years ending after June 15, 2004 for accelerated filers and to fiscal years ending after March 15, 2005 for other companies. The SEC also altered the text and filing procedures for CEO and CFO certifications, and this change will apply to most companies for the quarters ending on or after June 30, 2003.

What is the essence of these new rules?

The new rules define a new term—“internal control over financial reporting”—and require that:

- Management make an annual assessment of the company’s internal control over financial reporting, and include a report of that evaluation in the annual report;
- The company provide a report of its independent auditors attesting to management’s assessment;
- The company report quarterly any material changes in their internal control over financial reporting; and
- CEO and CFO certifications be filed as exhibits to the periodic reports for which they are required.

How is the new term “internal control over financial reporting” defined?

The text of the lengthy definition of this term is attached at the end of this update as [Appendix A](#). In essence, “internal control over financial reporting” means a process implemented by the board, management and other personnel that is designed to provide reasonable assurance regarding the reliability of financial reporting and preparation of financial statements in accordance with GAAP. The definition includes policies and procedures pertaining to the maintenance of records that accurately reflect the acquisition and disposition of assets. It also includes policies and procedures providing reasonable assurance that transactions are recorded in a way that permits preparation of financial statements in accordance with GAAP and that receipts and expenditures are made only in accordance with the authorizations of management. The term also includes policies and

procedures that provide reasonable assurance regarding prevention or detection of unauthorized acquisition or use of corporate assets that could have a material effect on the financial statements.

What is the relationship between “internal control over financial reporting” and “disclosure controls and procedures”?

“Disclosure controls and procedures” was defined in August 2002, to refer to controls and other procedures designed to ensure that information that is required to be included in SEC filings is recorded, processed, summarized and reported in a timely basis. This term is broader than the concept of internal control over financial reporting, but the SEC also indicated that there may be elements of a particular company’s internal control over financial reporting that are not part of its disclosure controls and procedures certainly. Disclosure controls and procedures include at least that much of internal control over financial reporting as is necessary reasonably to assure that transactions are recorded as necessary to permit the preparation of financial statements in accordance with GAAP.

What standard does management use to evaluate the company’s internal control over financial reporting?

Management must base its evaluation on a suitable, recognized control framework. The integrated framework published in 1992 by the Treadway Commission’s Committee of Sponsoring Organizations (“COSO”) is identified as one suitable domestic framework for this purpose. The SEC notes that other frameworks exist outside the US and other domestic frameworks may develop in the future.

Management’s assessment of the company’s internal control over financial reporting must be based on procedures that are sufficient both to evaluate the design of these controls and to test their effectiveness. How the evaluation is conducted may vary from company to company as the rules do not specify any method or procedure for performing the assessment. However, the evaluation must be supported by evidence, including documentation, providing reasonable support:

- For the evaluation of whether the control is designed to prevent or detect material misstatements or omissions;
- For the conclusion that the tests were appropriately planned and performed; and
- That the results of the tests were appropriately considered.

This evidence will also be required for the company's independent auditor to perform its attestation services.

What does management's report on internal control have to contain?

The annual report (typically, Form 10-K) must include an internal control report by management that contains:

- 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 conduct the evaluation (*e.g.*, the COSO framework);
- Management's assessment of the internal control over financial reporting as of the end of the most recent fiscal year, including a statement as to whether these controls are effective; and
- A statement that the company's registered public accounting firm that audited its financial statements has issued an attestation report on management's assessment.

The rules also require that the registered public accounting firm's attestation report be filed as part of the annual report.

In making its assessment of the company's internal control over financial reporting, management must report any "material weaknesses" that it discovers and, further, cannot conclude that the controls are effective if a material weakness is found to exist. "Material weakness" has the same meaning for this purpose as is ascribed to this term under generally accepted auditing standards.

Is this only an annual report, or is there some required quarterly updating?

The full assessment of internal control over financial reporting is to be done annually. Then management, with the CEO and CFO participating, must evaluate quarterly whether any change in the company's internal control over financial reporting has occurred that materially affected the control or is reasonably likely to do so. Any such change must be described in the Form 10-Q that covers the quarterly period or, in the event of fourth quarter changes, in the Form 10-K. Complete quarterly assessments of internal control over financial reporting are not required. On the other hand, disclosure controls and procedures must still be evaluated for effectiveness on a quarterly basis.

What is the new rule about filing CEO and CFO certifications as exhibits?

Until now, Section 302 certifications of the CEO and CFO were required to be filed as part of the Form 10-K or Form 10-Q (immediately behind the signature page), while Section 906 certifications were to “accompany” the filing. Now both certifications will be exhibits to the report with which they are filed. The Section 906 certifications are deemed “furnished” to the SEC, rather than filed, and unless otherwise expressly provided will not be incorporated into the company’s 1933 Act registration statements.

The SEC revised the required text of the Section 302 certification in light of the substantive changes about disclosure controls and internal control mandated in the final rule. The certification now includes an acknowledgement by the CEO and CFO of their obligation to maintain internal control over financial reporting, as well as disclosure controls and procedures. The evaluation of disclosure controls and procedures must be made as of the last day of the quarter, rather than within 90 days prior to the date the report is filed.

Where do these evaluation and reporting requirements appear in the SEC’s rules and forms?

The new rules are reflected as amendments to a several SEC rules and forms, including:

- New section 2-02 of Regulation S-X requires the company’s registered public accounting firm to attest to management’s assessment of internal control over financial reporting in the annual report;
- New Item 308 of Regulation S-K requires the annual report to include management’s report and the registered public accounting firm’s attestation of such report, and the quarterly reports to include disclosure of any material changes in the company’s internal control over financial reporting;
- Item 307 of Regulation S-K now relates only to disclosure of management’s conclusion about the effectiveness of disclosure controls and procedures;
- New Item 601(b)(31) of Regulation S-K sets forth the form of Section 302 certification that now must be filed as an exhibit;
- New Item 601(b)(32) of Regulation S-K provides for furnishing the Section 906 certification as an exhibit;
- Rule 13a-14 was revised to reflect the requirement to file the Section 302 and 906 certificates as exhibits; and
- Rule 13a-15 was revised to include the requirements that management evaluate disclosure controls and procedures and internal control over financial reporting and to define these terms.

When are these new rules effective?

For companies that are accelerated filers as of the end of their first fiscal year ending on or after June 15, 2004, management reports on internal control over financial reporting, and the corresponding attestation and report of the independent auditor, will be required in the annual report for that year. Other companies must begin to comply for the first fiscal year ending on or after April 15, 2005. Quarterly reports on material changes in internal control over financial reporting will be required beginning with the first quarterly report after the first annual report containing such management report.

Companies may comply with these requirements before they become applicable to them. The obligation to file Section 302 and 906 certifications as exhibits becomes effective in reports that are **due on or after August 14, 2003**. Therefore, this requirement will apply to Forms 10-Q for the upcoming quarter that ends on June 30 for many companies. The requirement that the certifying officers evaluate disclosure controls and procedures as of the last day of the quarter will also apply at that time. Subsection 4(b) of the new Section 302 certifications, concerning internal control over financial reporting, does not become effective until the first annual report that contains the report on internal control.

Who should I call when I have questions?

If you have any questions about these new requirements, please feel free to contact any member of your Fenwick & West team. You may also contact Dan Winnike (dwinnike@fenwick.com) or Horace Nash (hnash@fenwick.com) who contributed to this update.

To review all of our corporate and securities law updates and other Fenwick & West publications, please visit: http://www.fenwick.com/pub/corp_pubs/Sub_Pubs/Public_Company_Securities.htm.

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Appendix A - Text of Definition

“The term internal control over financial reporting is defined 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 issuer’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 issuer;

(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 issuer are being made only in accordance with authorizations of management and directors of the issuer; and

(3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements.”