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Internal Control

On May 27, 2003, the Securities and Exchange Commission completed what for now is its most pronounced step in rulemaking under the Sarbanes-Oxley Act of 2002. It adopted much-anticipated and demanding final rules under Section 404 of the Sarbanes-Oxley Act requiring annual management assessments of the effectiveness of internal control over financial reporting of public companies. [1] Also following the statute's lead, the SEC will require each company's accountant to attest to these assessments.[2]

"Accelerated filers" must comply with the new rules regarding internal control reports beginning with the first fiscal year ending after June 15, 2004, while all others, including small business and foreign private issuers, will have another ten months.

Please note that in February 2004, the SEC extended the compliance date for these new rules. Under the new compliance schedule, an "accelerated filer" must begin to comply with the new rules for its first fiscal year ending after November 15, 2004, and any other filer must begin to comply for its first fiscal year ending after July 15, 2005. In addition, on March 9, 2004, the Public Company Accounting Oversight Board adopted a final standard on audit of internal control over financial reporting.

Background

Congress, the SEC and other federal regulators have long advocated internal control systems to inhibit fraud and financial irregularities. Since 1977, public companies have been required to maintain internal accounting controls.[3] Moreover, on two separate occasions in the past 25 years, the SEC has proposed that management of public companies be required to report publicly on the adequacy of these controls. In 1993, the Federal Deposit Insurance Corporation actually imposed such an internal control report requirement, but this only applies to certain depository institutions.[4] The recent impetus for reform that culminated with the Sarbanes-Oxley Act helped coalesce widespread support for extending internal control reporting requirements to all public companies. [5]

The SEC's new rules on internal control reports, for many companies, will represent the most significant single requirement associated with the Sarbanes-Oxley Act, if only from the standpoint of compliance costs. Large public companies may have to devote many thousands of hours to comply with the new rules, and compliance will involve significant expense for such things as software and systems upgrades, additional personnel and fees paid to auditors.

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[1] *See* Release No. 33-8238 (June 5, 2003) http://www.sec.gov/rules/final/33-8238.htm

[2] The SEC proposed rules on this subject in October 2002. *See* Release No. 33-8138 (Oct. 22, 2002) http://www.sec.gov/rules/proposed/33-8138.htm

[3] *See* Section 13(b)(2)(B) of the Securities Exchange Act of 1934, added by the Foreign Corrupt Practices Act of 1977.

[4] The FDIC rules, adopted under Section 36 of the Federal Deposit Insurance Act, require depository institutions to file reports containing management assessments of the effectiveness of internal control systems, and such assessments must be attested to by outside auditors. *See* Annual Independent Audits and Reporting Requirements, 58 Fed. Reg. 31,332 (July 2, 1993) (codified at 12 C.F.R. 363.3).

[5] Among other things, the new rules enact amendments to Forms 10-Q and 10-K, Rules 13a-14, 13a-15, 15d-14 and 15d-15 under the Exchange Act, and Item 307 of Regulation S-K, as well as adding new Item 308 and Exhibits 31 and 32 to Item 601 of Regulation S-K.

Congress and the SEC concluded that the benefits to be derived from the new rules outweigh these costs. The new requirements will demand rigorous review that should upgrade internal controls and, in turn, the accuracy and reliability of financial statements and reports. It is for this reason that several SEC commissioners and senior staff members hailed the internal control reporting requirement as one of the most important elements of the Sarbanes-Oxley Act.[6]

The SEC received 61 comment letters on the proposed rules for internal control reports, many of which were supportive. There were, however, also significant objections and concerns voiced by commenters, which the SEC accommodated in part in the final rules by extending the proposed deadline for compliance and eliminating the proposed requirement to perform quarterly evaluations of internal controls.

Management Must Report on "Internal Control Over Financial Reporting"

New Item 308 of Regulation S-K requires an annual report by management regarding the company's "internal control over financial reporting" -- which means a process designed by management to provide reasonable assurance regarding the reliability of financial reporting and preparation of financial statements in accordance with generally accepted accounting principles, or GAAP. The SEC defined the phrase "internal control over financial reporting" by reference to the financial reporting aspect of the definition of internal control contained in the COSO Report. (See box on page 4.)[7] Generally, internal control over financial reporting includes policies and procedures that are designed to

- maintain records to reflect the company's transactions accurately;
- record transactions in a manner that permits the company to prepare financial statements in accordance with GAAP and effect receipts and expenditures only as authorized by management and/or the board of directors; and
- prevent or detect unauthorized acquisition, use or disposition of the company's assets that could have a material effect on the financial statements.[8]

The COSO Report addresses internal control in the context of three broad objectives: financial reporting, effective business operations, and compliance with applicable laws. Because the SEC's new rules encompass only internal control over financial reporting, the scope of internal control to be reported upon will not include

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[6] Speaking at the open meeting at which the new rules were adopted, Chairman William Donaldson noted that the new rules would hold company executives accountable. Commissioner Harvey Goldschmid said the rules are "…certainly among the most important things the Commission has done for at least a year." Alan Beller, director of the SEC's Division of Corporation Finance, described the rule as "the single most important step" under the Sarbanes-Oxley Act to improve financial reporting.

[7] The definition of internal control in the SEC's proposed rule, by contrast, was based on the definition of internal control structure contained in the AICPA's Codification of Statements on Auditing Standards Section 319. The SEC explained that it made this change in response to comments on the proposed rule, which, among other things, noted that AU Section 319 is intended to provide guidance to auditors, not company management, and that the COSO definition is the predominant term used by both companies and auditors.

[8] *See* new Exchange Act Rules 13a-15(f) and 15d-15(f). Although the definition of "internal control over financial reporting" differs in some respects from the definition of "internal accounting controls" in Section 13(b)(2)(B) of the Exchange Act, the SEC noted in its adopting release that it views the two definitions as consistent with each other.

controls designed to achieve effective and efficient business operations or compliance with applicable laws and regulations.[9]

As defined by the new rules, internal control is best understood as a process, *i.e*. a means to achieving an end -- reliable and accurate financial statements and financial reports. As such, while there may be many common elements among different internal control systems, each company's internal control system must be designed to accommodate that company's specific operations and risks. A control process that is appropriate for a large, multinational company may not be appropriate for a smaller company. It is also clear from the SEC's reliance on the COSO Report that internal control systems are not static and must be flexible and dynamic so as to evolve and reflect the changing operations, risk profile and overall business environment of the company.

The Internal Control Report

Management's report on internal control over financial reporting must be included in the company's annual report filed with the SEC and must contain the following:

- a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company;
- a statement identifying the framework used by management to evaluate the effectiveness of this internal control;
- management's assessment of the effectiveness of this internal control as of the end of the company's most recent fiscal year and disclosure regarding any "material weaknesses" in such control; and
- a statement that the company's auditor has issued an attestation report on management's assessment.

Management Responsibility for Internal Control. Although implicit in the internal control reporting requirement, the new rules add an explicit requirement that public companies maintain internal control over financial reporting.[10] This is in addition to the existing requirement to maintain internal accounting controls under Exchange Act Section 13(b)(2)(B).

Internal Control Framework. The internal control report must identify the framework used by management for its evaluation of internal control effectiveness. As used by the SEC, the concept of "framework" encompasses a set of criteria or measurement standards that can be used to evaluate the effectiveness of internal control. The new rules require such framework to be a suitable, recognized control framework established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment. To be deemed "suitable," the framework must be free from bias and permit reasonably consistent qualitative and quantitative measurements of a company's internal control. It also must be sufficiently complete so as not to omit factors that would alter a conclusion about the effectiveness of internal control, and it must be relevant to an evaluation of internal

[9] With respect to compliance with applicable laws, however, the SEC noted in its adopting release that internal control over financial reporting must address compliance with applicable laws and regulations directly related to the preparation of financial statements, such as the SEC's financial reporting requirements.

[10] See amended Exchange Act Rules 13a-15(a) and 15d-15(a).

control over financial reporting.[11] The SEC's adopting release specifically endorses the framework outlined in the COSO Report but leaves open the possibility that other frameworks could be used, as long as they satisfy the due-process criteria described above.[12]

The COSO framework consists of five interrelated components:

- an overall control environment that encourages integrity, ethical behavior and competence;
- mechanisms for risk assessment;
- control activities, such as policies and procedures;
- information and communication systems; and
- monitoring and modification of the internal control system.

These five components are intended to provide assurances that the objectives of the internal control system, reliable and accurate financial reporting, will be achieved. While they apply to all entities, regardless of size, the components will work in different ways with companies of different sizes and complexities to achieve effective control. For instance, the risk assessment mechanisms for a large, global natural resource company that actively engages in commodities trading will differ significantly from those used by a medium-sized, domestic electronics manufacturer.

The COSO Report

COSO refers to the Committee of Sponsoring Organizations of the National Commission on Fraudulent Financial Reporting, also known as the Treadway Commission. The joint sponsors of COSO are the American Accounting Association, the American Institute of Certified Public Accountants, the Financial Executives Institute, the Institute of Internal Auditors, and the Institute of Management Accountants (formerly the National Association of Accountants). The Treadway Commission was formed in 1985 as a private sector initiative to examine the causes of fraudulent financial reporting and develop recommendations for public companies, their independent auditors, and regulators. Following publication of an initial report by the Treadway Commission in 1987, COSO undertook an extensive study of internal control to establish a common definition that would serve the needs of companies, independent public accountants, legislators, and regulators, and to provide a broad framework of criteria against which companies could evaluate the effectiveness of their internal control systems. The report produced as a result of that survey was COSO's *Internal Control -- Integrated Framework* (1992) (the "COSO Report"). The COSO Report was supplemented in 1994 with an addendum to the section entitled "Reporting to External Parties." More information about COSO is available on its website, http://www.coso.org/.

Of the five components comprising the COSO framework, it is fair to say that the third component, control activities, is the most widely recognized; indeed, casual observers often cite it as the only element of an internal control system. Some examples of specific control processes and procedures that would fall within this component in the area of financial reporting include the following:

[11] *See* Section II(B)(3)(a) of the SEC's adopting release.

[12] The SEC cites two other existing control frameworks that it considers suitable: the *Guidance on Assessing Control* published by the Canadian Institute of Chartered Accountants and the *Turnbull Report* published by the Institute of Chartered Accountants in England and Wales.

- controls over initiating, recording, processing and reconciling account balances, classes of transactions and disclosure and related assertions in financial statements;

- fraud programs and controls;

- controls related to selection and application of appropriate accounting policies;

- controls over significant non-routine transactions; and

- controls over the financial reporting process, including how amounts are summarized and adjusted from the underlying books and records into the annual and quarterly financial statements.

Beyond the control activities component, however, public companies and their auditors will need to ensure that all five components of the COSO framework are addressed in order to comply with the new report and attestation requirements. With respect to control environment, as noted by the SEC in its adopting release, the composition of a company's board of directors and audit committee, as well as how directors fulfill their financial reporting responsibilities, are key aspects of the company's control environment.[13] Regarding risk assessment, the company must maintain effective qualitative and quantitative methods for identifying, prioritizing, and analyzing higher-level risks posed by external and internal activities. Information and communication systems must promote and encourage free flow of information, and those with key roles in the internal control process, such as internal auditors, outside auditors and the audit committee, must communicate with each other regarding internal control issues regularly and effectively. Finally, companies must systematically monitor and evaluate the effectiveness of their internal control over financial reporting.[14]

Method of Evaluation of Internal Control. The COSO Report gives detailed guidance, illustrations and practical suggestions on methods of testing internal control systems and assessing their effectiveness. According to the COSO Report, determining such effectiveness is a subjective judgment derived from an assessment of whether the framework's five components described above are present and functioning. The COSO Report provides that all five criteria must be satisfied in order to conclude that internal control over financial reporting is effective.

In its adopting release, the SEC notes that, while methods of evaluating internal control over financial reporting will vary from company to company, it is fundamental for an evaluation methodology to retain evidence that provides reasonable support for management's assessment.[15] Developing and maintaining such evidence is an inherent element of internal control. Inquiry alone is not sufficient.

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[13] A beneficial side effect of the Sarbanes-Oxley initiatives is that by complying with the various new corporate governance requirements imposed by the SEC and stock exchanges under the Sarbanes-Oxley Act, most companies will also realize improvements in their overall control environments.

[14] These processes may benefit from the flow of information and communication as a result of the disclosure controls and procedures required by Rules 13a-15(e) and 15d-15(e) under the Exchange Act.

[15] The SEC explicitly requires that such documentation be maintained, in an Instruction to new Item 308 of Regulation S-K.

"*Material Weaknesses" in Internal Control*. Under the new rules, management will not be able to conclude that the company's internal control over financial reporting is effective if there is a "material weakness" in such control. Any such material weakness must also be specifically disclosed.[16]

The term "material weakness" has the meaning given such term under generally accepted auditing standards (or GAAS), including the AICPA's Codification of Statements on Auditing Standards Section 325 ("AU Section 325"). Under AU Section 325, a material weakness is a "significant deficiency" in the control system where there is more than a relatively low level of risk of material errors in the financial statements going undetected by company employees in a timely fashion. A "significant" deficiency is one that could adversely affect the company's ability to record, process, summarize, and report financial data consistent with the company's financial statements.[17] The SEC suggests that an aggregation of significant deficiencies could constitute a material weakness, even where none of the individual significant deficiencies is a material weakness.[18]

This aspect of the new rules is significant in that it imposes a new disclosure obligation that rests on a determination by management -- about whether there are material weaknesses in internal control -- that historically was within the purview of the company's auditors. Determining whether a particular deficiency in control is significant enough to constitute a material weakness will require a careful weighing of the facts and circumstances surrounding the deficiency and an analysis of the potential impact of the deficiency, if undetected in a timely manner, on the company's financial statements. The experience of management in making such assessments will vary from company to company based on familiarity with internal control methodologies, and, in many cases, senior officers initially may be ill-equipped to make these determinations effectively and with confidence. One hypothetical example of a material weakness might be a serious malfunction of the company's enterprise software system used to track orders, invoices and collections, with the result that a significant portion of transactions are not recorded, or are recorded late or incorrectly. Another, purely hypothetical, example of a material weakness might be an accounting process that permits material amounts of revenue or expenses to be entered manually without sufficient supporting documentation and/or appropriate authorizations.

Because the definition of material weakness used by the SEC is based on GAAS, it is possible that the Public Company Accounting Oversight Board, or PCAOB, will take action that will modify this definition of material weakness.[19] In this regard, it is worth noting that the AICPA's Auditing Standards Board, or ASB, issued an exposure draft in March 2003, which, among other things, proposed certain streamlining changes

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[16] Prior to being amended by the new rules, Item 307 of Regulation S-K has required certain disclosures, on a quarterly and annual basis, regarding significant changes in internal controls, including actions taken by the company to correct significant deficiencies and "material weaknesses" in internal control.

[17] Technically, AU Section 325 uses the term "reportable condition" instead of "significant deficiency" to define material weakness. However, the SEC's adopting release states that "reportable condition" has the same meaning as "significant deficiency." While this confirms prevailing usage of such terms, there does not appear to be any explicit statement to this effect in relevant accounting literature.

[18] *See* Section II(B)(3)(c) of the SEC's adopting release, including footnote 73.

[19] The PCAOB is charged with adopting auditing standards applicable to auditors of public companies. In the adopting release and at the open meeting at which the new internal control report rules were adopted, the staff confirmed that the PCAOB is now the sole authority with respect to setting auditing and attestation standards for firms auditing public companies.

to the definitions of the terms "significant deficiency" and "material weakness."[20] It is likely that the PCAOB will consider such exposure draft in taking any action with respect to the definition of material weakness.

Attestation of Management's Assessment. Management's internal control report must also contain a statement that the company's auditor has provided an attestation of management's assessment regarding the effectiveness of the company's internal control over financial reporting. The new rules require the attestation to be included in the company's annual report containing management's report on internal control.[21]

In the open meeting at which the new rules were adopted, the SEC staff stressed that the attestation report does not cover the effectiveness of the company's internal control, but, rather, goes to management's assessment of that effectiveness. The significance of this distinction is not entirely clear, however. The evidence required by the auditor to support management's assertion that controls are effective may not be materially different from the evidence that would be required to support an attestation of the effectiveness of the controls themselves.

Standards for Preparation of Auditor's Attestation Report

The auditor's attestation report must be prepared in accordance with standards for attestation engagements issued or adopted by the PCAOB. The SEC adopted a generous transition period for compliance with the new rules (described below) to afford the PCAOB a reasonable opportunity to evaluate existing attestation standards, adopt modifications to such standards, or adopt wholly new standards sufficiently far in advance of the time when public companies and their auditors will need to commence the substantial work necessary to prepare such reports. The SEC staff has publicly suggested that it would be helpful if the PCAOB could take action with respect to such attestation standards by the end of 2003.

In April 2003, the PCAOB adopted interim attestation standards by endorsing existing attestation standards described in the ASB's Statements on Standards for Attestation Engagements ("SSAE") and related interpretations and Statements of Position.[22] The most directly relevant source within such standards is Section 501 of SSAE No. 10 ("AT Section 501"),[23] which, among other things, requires that

- management accept responsibility for the effectiveness of internal controls;
- management evaluate the effectiveness of internal controls, using suitable criteria; and

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[20] *See* Exposure Draft - Proposed Statements on Auditing Standards; Proposed Statement on Standards for Attestation Engagements, prepared by the AICPA Auditing Standards Board (Mar. 18, 2003) ("ASB Exposure Draft").

[21] Although the rules do not specify the location of the attestation report, the adopting release suggests that the appropriate location for both the attestation report and management's report on internal control would be near the company's MD&A disclosure, or in a portion of the annual report immediately preceding the financial statements. The attestation report need not be included as part of the accountant's audit opinion on the financial statements.

[22] *See* PCAOB Rule 3300T (PCAOB Rel. No. 2003-006) (Apr. 16, 2003).

[23] Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of SSAE No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT Section 501), as amended. AT Section 501 has been used since 1993 to report on management assessment of internal controls by financial institutions pursuant to rules adopted by the FDIC.

- sufficient evidential matter exist, or be developed, to support management's evaluation.[24]

AT Section 501 also provides guidelines with respect to the kinds of tests that should be conducted by the auditor to evaluate the operating effectiveness of the internal controls. These tests would ordinarily include inquiries of appropriate personnel, inspection of relevant documentation, observation of the company's operations, and random (or a sampling of) reapplications or reperformances of the internal controls. The auditor can review tests performed by management but is also required to obtain sufficient evidence to support its opinion, and, if applicable, to corroborate the results of tests performed by management.

In considering whether to make any changes to the interim attestation standards, the PCAOB will also likely consider the ASB's exposure draft on attestation standards for internal controls issued in March 2003.[25] The proposed standards contained in the exposure draft would generally enhance, clarify and expand existing guidelines for auditors' evaluation and attestation of the effectiveness of internal control. While the exposure draft is not binding on the PCAOB, it is likely that at least some of these suggestions will be incorporated by the PCAOB.

Quarterly Evaluation of Material Changes

Under the new rules management will be required to perform quarterly evaluations of changes that have materially affected, or are reasonably likely to have a material effect on, the company's internal control over financial reporting. The company will also have to disclose any such changes in its quarterly report. This disclosure requirement replaces the paragraph in existing Item 307 of Regulation S-K regarding quarterly disclosure of changes in internal controls and corrective actions and is incorporated in new Item 308 of Regulation S-K.[26] The new rules do not explicitly require disclosure about the reasons for any change that occurred during the quarter, but the SEC's adopting release notes that companies will have to determine, on a facts and circumstances basis, whether the reasons for the change, or other information about the circumstances surrounding the change, are material and required to be disclosed.

As initially proposed by the SEC, the rules implementing Section 404 would have gone beyond the legislative requirements of such section by requiring not only annual but also quarterly evaluations of the effectiveness of internal control. Commenters expressed significant concern that quarterly evaluations of internal controls would impose undue costs and burden, especially in light of the new accelerated deadlines for filing Form 10-Q reports. In response, the SEC did not adopt the proposal to require quarterly evaluations of the effectiveness of internal control.

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[24] Documentation to satisfy this evidentiary requirement could take various forms. AT Section 501 suggests the following types of documentation that may be appropriate to serve as a basis for management's assertions: policy manuals, accounting manuals, narrative memoranda, flowcharts, decision tables, procedural write-ups, and completed questionnaires.

[25] *See* ASB Exposure Draft.

[26] The modified disclosure is also reflected in a revised form of the officer certification required under Section 302 of the Sarbanes-Oxley Act, as discussed below under "Changes to Section 302 Officer Certifications and Related Disclosure."

Overlap of “Internal Control” and “Disclosure Controls and Procedures”

In its adopting release, the SEC addresses a thorny topic that has generated considerable commentary and varying advice by legal practitioners -- whether, and to what extent, internal control over financial reporting overlaps with disclosure controls and procedures.

Disclosure controls and procedures are controls and other procedures designed to ensure that information required to be disclosed in reports filed under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in the SEC’s rules and forms.[27] In light of the requirement in Item 307 of Regulation S-K for annual and quarterly disclosures about the effectiveness of disclosure controls and procedures, there has been some uncertainty as to whether, and to what extent, “internal control” should be considered part of “disclosure controls and procedures.” To the extent that some parts of internal control are included within disclosure controls and procedures, Item 307 would, arguably, require both annual and quarterly evaluations by management of the effectiveness of such controls.

In the adopting release, the SEC attempts to provide some guidance on this issue. The SEC states that while there is substantial overlap between the two sets of controls, they are not co-extensive. Some elements of disclosure controls and procedures are not subsumed by internal control over financial reporting, and some elements of internal control are not subsumed by disclosure controls and procedures. As an example of the overlap between the two sets of controls, the SEC cites those components of internal control over financial reporting that provide assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP. These controls should also generally be considered part of disclosure controls and procedures.

Given the overlap cited by the SEC, the quarterly evaluations of disclosure controls and procedures required by Item 307 necessarily require an evaluation by management of those elements of internal control included within disclosure controls and procedures. The SEC’s adopting release offers some perspective that may allow companies reasonably to conclude that a lesser level of assessment of such internal control may be appropriate than that required by the new rules pertaining to annual assessments of internal control. First, the SEC notes that management has the ability to make judgments that quarterly evaluations may properly focus on developments since the most recent evaluation, areas of weakness or continuing concern, or other matters that merit attention. Second, the SEC suggests that the level of evaluation of those elements of internal control that are subsumed within disclosure controls and procedures should be informed by the underlying purpose of disclosure controls and procedures.[28] These general statements, while not providing any “black and white” boundaries, do reflect the SEC’s awareness of, and sensitivity to, the concern that without some differentiation, the existing requirement to evaluate disclosure controls and procedures on a quarterly basis could create a “back door” requirement to also perform quarterly evaluations of internal control over financial reporting of the same scope as annual evaluations. Finally, as a practical matter, the lack of a quarterly requirement for an

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[27] *See* Rules 13a-15(e) and 15d-15(e) under the Exchange Act.

[28] For example, the SEC suggests that even where systems testing of the internal control component would be required as part of the annual evaluation of internal control, management could make a different determination of the appropriate nature of the evaluation of that component for purposes of a quarterly evaluation of disclosure controls and procedures. *See* Section II(E) of the adopting release, including footnote 93.

attestation opinion will surely limit somewhat the scope of management's quarterly review of those elements of internal control subsumed in disclosure controls and procedures.[29]

Changes to Section 302 Officer Certifications and Related Disclosure

A number of changes are being made to the text of the officer certification required under Exchange Act Rules 13a-14 and 15d-14. These changes include modifications to conform to the new requirements relating to evaluations of internal control over financial reporting, but also encompass other changes not related to the new internal control rules. In addition, similar changes are being made to corresponding rules and form items that address annual and quarterly disclosures regarding management's evaluations of disclosure controls and procedures and internal control over financial reporting.[30]

The officer certification and corresponding periodic disclosure regarding management's evaluation of controls are modified as follows:

- the evaluation date for disclosure controls and procedures is changed from "as of a date within 90 days of the filing date" to "as of the end of the period" covered by the quarterly or annual report;

- a statement is added to the effect that the principal executive and financial officers are responsible for designing disclosure controls and procedures and internal control over financial reporting, or having such controls and procedures designed under their supervision;

- the term "internal control over financial reporting" is incorporated; and

- the paragraph that previously required disclosure regarding significant changes in internal controls and corrective actions is replaced with a provision that requires quarterly disclosure of any change in internal control over financial reporting that has materially affected, or is reasonably likely to have a material effect on, internal control over financial reporting. As part of this modification, the phrase "or in other factors" that was previously included is deleted.

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[29] Although the SEC seems to acknowledge the propriety of less rigorous quarterly evaluations of those elements of internal control included in disclosure controls and procedures, there is a risk that subsequent, more rigorous review in connection with the required annual evaluation and related auditor attestation process may identify deficiencies that, had they been identified as part of the quarterly evaluation of disclosure controls and procedures, might have led management to conclude that its controls were not effective.

[30] *See* Items 307 and 308 of Regulation S-K, Rules 13a-14, 13a-15, 15d-14, and 15d-15 under the Exchange Act, revised Item 4 of Form 10-Q, and new Item 9A of Form 10-K.

New Text of Section 302 Certifications

Note: the portions in bold italics may be omitted until such time as the registrant is required to comply with the new rules on internal control over financial reporting.

I, [identify the certifying individual], certify that:

1. I have reviewed this [specify report] of [identify registrant];
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) ***and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f))*** for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

   (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: ....

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[Signature]
[Title]

Submitting Officer Certifications as Exhibits

Under the new rules, the officer certifications required under Sections 302 and 906 of the Sarbanes-Oxley Act will now be required to be filed (or, in the case of the Section 906 certification, furnished) as exhibits to the applicable report.[31] This change is intended to enhance access to the certifications by making them easier to locate and retrieve in the SEC's EDGAR system The complete text and form of each of the certifications is now set forth under the applicable exhibit number in Item 601 of Regulation S-K. In recognition of the different standards for providing such certifications set forth in the Sarbanes-Oxley Act, the Section 906 officer certification may be furnished to, rather than filed with, the SEC.[32] If the EDGAR system is not updated by the time the foregoing rules become effective, companies should submit the required certifications under Exhibit 99.

Transition Periods and Effective Date

Rules Relating to Internal Controls and Annual Reports. Companies that are "accelerated filers" as of the end of their first fiscal year ending after June 15, 2004 must comply with the following new rules regarding internal controls and annual internal control reports beginning with the annual report for that fiscal year:

- new Item 308(a) and (b) regarding management's annual report regarding the effectiveness of internal control over financial reporting and related auditor attestation report;
- those portions of new Exchange Act Rules 13a-15(a) and 15d-15(a) that require companies to maintain internal control over financial reporting; and
- new Exchange Act Rules 13a-15(c) and 15d-15(c), requiring annual evaluations of internal control over financial reporting.

All other companies, including small business and foreign private issuers, must comply with the above requirements beginning with their first fiscal year ending after April 15, 2005.

Rules Relating to Quarterly Evaluations of Changes in Internal Controls. Companies must comply with the rules relating to quarterly evaluations of changes in internal controls beginning with the first periodic report due after the first annual report that contains management's report on internal control over financial reporting.[33] Thus, accelerated filers with a December 31 fiscal year end must begin complying with the quarterly evaluation requirement beginning with their Form 10-Q report for the quarter ended March 31, 2005.

The foregoing transition dates are more generous than had been anticipated by many observers. This is, in part, to allow the PCAOB to issue standards governing the required attestation report, but also in recognition of the substantial amount of time and

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[31] The Section 302 officer certification (required under Exchange Act Rules 13a-14(a) and 15d-14(a)) must be filed as new Exhibit 31 under Item 601 of Regulation S-K. The Section 906 officer certification (required under Exchange Act Rules 13a-14(b) and 15d-14(b)) must be furnished as new Exhibit 32 under Item 601 of Regulation S-K.

[32] Section 906 of the Sarbanes-Oxley Act requires that the certification "accompany" the periodic report to which it relates, whereas Section 302 of the Sarbanes-Oxley Act requires the certification to be included "in" the periodic report.

[33] These are new Exchange Act Rules 13a-15(d) and 15d-15(d).

work that will be required for registrants to be in a position to deliver an internal control report and enable their auditors to deliver an attestation report.

Changes to Section 302 Officer Certification, Corresponding Periodic Disclosure Requirements, and Filing Method of Officer Certifications. The other changes adopted by the SEC and described above will become effective August 14, 2003. Thus, those companies whose second quarter Form 10-Q report is due on August 14, 2003 will need to comply with these changes if their Form 10-Q is filed on or after such date.

With respect to the revised form of Section 302 officer certifications, companies will be permitted to file a modified version of the certification to omit certain portions addressing internal control over financial reporting, until such time as the company is required to comply with the new internal control rules as described above. Specifically, until such time, companies may omit the following from the Section 302 certification:

- that portion of the introductory language in paragraph 4 referring to the certifying officers' responsibility for establishing and maintaining internal control over financial reporting; and

- paragraph 4(b), which must be provided in the first annual report required to contain management's internal control report and thereafter.

Exceptions

Financial institutions already subject to internal control reports under banking regulations can submit a single report that meets the requirements of both the FDIC's regulations and the new rules. Asset backed issuers and registered investment companies are not subject to the new rules regarding reports by management regarding internal control over financial reporting.

Conclusions and Commentary

There is no question that compliance with the new rules will be costly, laborious and time intensive. Large national and multinational companies may find that they need to devote many thousands of hours to the compliance effort and spend considerable sums of money on software and financial systems upgrades, additional personnel and additional audit fees. The work that will be required generally falls into two broad categories: work necessary to enable management to assert that the company's internal control over financial reporting is effective, and work required to document and support such assertion so that the company's auditor can deliver an attestation report with respect to management's assertion.

There remains some uncertainty as to the precise scope of documentation, test results and other evidence that will be required to be provided to the auditor to enable it to deliver an attestation report on management's assessment. While conceptually this requirement is relatively easy to understand, since it correlates to a similar process in the annual audit of financial statements, an entirely different set of documentation will be required for an attestation report. In many cases, it is likely that companies historically have not documented all aspects of their internal control systems, or conducted and documented tests thereof, in as comprehensive a fashion as will be required to enable auditors to deliver an attestation report with respect to such matters.

Both outside and internal auditors will play a significant role under the new rules. At the open meeting at which the new rules were adopted, the SEC's staff confirmed its view that the preparation and delivery of an attestation report by the company's regular accounting firm, as required by the new rules, would not hinder the independence of such firm. Many companies will want to consult with their outside auditor early in the process, to scope out the compliance process and agree on a timetable and action plan. But care needs to be taken to ensure that management, not the outside auditor, is ultimately responsible for designing and implementing the internal control systems. To the extent the outside auditor becomes involved in designing the system, its independence could be jeopardized, and it would be unable to provide an attestation report.[34] Some companies may find it useful to retain another audit firm (other than their regular outside auditor) to provide advice on the design, review, testing, enhancement and implementation of internal control systems.

Regarding internal auditors, an important question is whether, and to what extent, the outside auditor can rely on tests and other evaluations of internal control performed by the internal audit team as support for management's assertions regarding the effectiveness of control. Although the answer will vary with the specific facts and circumstances of each case, it seems likely that such reliance will not be permitted where management is relying to a very large degree on the internal auditors for purposes of making its assessment regarding internal control. This issue may also be addressed by the PCAOB in whatever action it takes to adopt or modify attestation standards.

David B.H. Martin
David H. Engvall

If you would like to learn more about the Securities Practice Group at Covington & Burling, please call any of the following:

Washington	David Martin	202.662.5128
New York	Bruce Bennett	212.841.1060
San Francisco	Andi Vachss	415.591.7069
London	Kelly Vance	44.20.7067.2040

[34] The SEC's adopting release notes that management's acceptance of responsibility for documentation prepared and testing performed by the auditor does not satisfy the auditor independence rules.