

October 11, 2004

## Internal Control Over Financial Reporting – Updated

In June 2003, the SEC adopted rules relating to internal controls for SEC reporting companies. The rules implement the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 (the “Act”). As a result of these new rules, SEC reporting companies will be subject to a new regime governing internal controls and new reporting requirements. These rules require:

- each reporting company, other than a registered investment company, to include in its annual report a report of management on the company’s “internal control over financial reporting” (a new term intended to avoid confusion with pre-existing concepts of internal controls);
- each reporting company’s independent auditor to audit management’s assessment of the company’s internal control over financial reporting;
- each reporting company to file the independent auditor’s attestation report as part of the company’s annual report; and
- management to evaluate any change in the company’s internal control over financial reporting that occurred during a fiscal quarter that has materially affected or is reasonably likely to materially affect, the company’s internal control over financial reporting.

The rules also make a number of conforming changes to the language of the certification required by Section 302 of the Act to conform to the newly adopted Section 404 rules. Additionally, the SEC revised its rules relating to the filing of Section 302 and 906 certifications.

“Accelerated filers” are required to comply with the new disclosure requirements relating to internal control over financial reporting beginning with the first fiscal year ending after November 15, 2004. All other reporting companies, including foreign private issuers, are required to comply with the new disclosure requirements beginning with the first fiscal year ending after July 15, 2005.

These rules apply to all reporting companies, both U.S. and non-U.S.

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This memorandum has been updated to reflect the views of the SEC staff with respect to the interpretation and application of Section 404 rules expressed in the publication *“Frequently Asked Questions – Management’s Report on Internal Control Over Financial Reporting and Disclosure in Exchange Act Periodic Reports”* (“FAQ”) released by the Office of the Chief Accountant and the Division of Corporation Finance in June 2004 and revised on October 6, 2004, as well as Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements* (“Auditing Standard No. 2”) approved by the Public Company Accounting Oversight Board (the “PCAOB”) in March 2004 and approved and adopted by the SEC in June 2004. Our memorandum *“PCAOB Approves Auditing Standard No. 2 for Review of Internal Control over Financial Reporting”* that discusses Auditing Standard No. 2 in greater detail is available on our website ([www.paulweiss.com](http://www.paulweiss.com)) under Capital Markets and Securities publications.

## **I. Background - Section 404 of the Act**

Section 404(a) of the Act directs the SEC to prescribe rules that would require each annual report filed pursuant to Section 13(a) or 15(d) of the Exchange Act to include an internal control report:

- stating management’s responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and
- containing an assessment, as of the end of the company’s most recent fiscal year, of the effectiveness of the company’s internal controls and procedures for financial reporting.

Section 404(b) of the Act requires every registered public accounting firm that prepares or issues an audit report for an issuer other than a registered investment company to attest to, and report on, management’s assessment of the issuer’s internal controls and procedures for financial reporting. The attestation and report required by Section 404(b) must be made in accordance with standards for attestation engagements “issued or adopted” by the Public Company Accounting Oversight Board (the “PCAOB”). Any such attestation may not be the subject of a separate engagement.

## **II. Internal Control Over Financial Reporting**

The rules implementing Section 302 of the Act, which the SEC adopted in a rulemaking release in August 2002 (the “August Release”), stated that the term “internal controls” as used in Section 302 of the Act is a pre-existing concept that pertains to a company’s financial reporting and control of its assets. Since this statement, the SEC has come to realize that there are a variety of definitions of the term “internal controls” and that its meaning has changed over time.

Therefore, to clarify the term, the SEC initially proposed to define “internal controls and procedures for financial reporting” to mean procedures that pertain to the preparation of financial statements for external purposes that are fairly presented in conformity with generally accepted accounting principles as addressed by Codification of Statements on Auditing Standards Section 319 or in any superseding definition or other literature that is adopted by the PCAOB. However, in response to comments, the SEC made several modifications to the proposed definition, including the defined term itself. The SEC adopted the term “internal control over financial reporting,” which is the predominant term used by companies and audit firms and, in the SEC’s opinion, best encompasses the objectives of the Act.

The final rules define “internal control over financial reporting” as:

A process designed by, or under the supervision of, the registrant’s principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant’s board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles and includes those policies and procedures that:

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

The definition is based on the financial reporting aspects of the definition of “internal control” established by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) and focuses on financial reporting, consistent with the definition initially proposed. The COSO framework defined internal control as “a process, effected by an entity’s board of directors, management and other personnel,” designed to provide reasonable assurance regarding the achievement of objectives in three distinct, but overlapping, categories:

- effectiveness and efficiency of business operations, which addresses an enterprise's basic business objectives, including profitability and performance goals;
- reliability of financial reporting, which addresses the preparation of reliable published financial statements as well as data derived from such statements such as earnings releases; and
- compliance with applicable laws and regulations.

As stated by the SEC, the scope of internal control encompasses policies, plans, procedures, processes, systems, activities, functions, projects and initiatives and endeavors of all types at all levels of a reporting company.

Because the new rules encompass only internal control over financial reporting, the definition as adopted does not encompass effectiveness and efficiency of business operations or compliance with applicable laws and regulations, with the exception of compliance with the applicable laws and regulations directly related to the preparation of financial statements, such as the SEC's financial reporting requirements. In the October FAQ, the SEC made clear that the rules require management to assess internal control over financial reporting of required supplementary information, which includes financial statement schedules required by Regulation S-X and supplementary disclosures required by the Financial Accounting Standards Board. Internal control over the preparation of this supplementary information need not be encompassed in management's assessment of internal control over financial reporting until the SEC issues new rules. The SEC has indicated that it is reviewing this issue for possible rule making as well as broader issues relating to oil and gas disclosure.

It should be noted that not all aspects of the Act and the rules promulgated thereunder fall within the definition of laws and regulations directly related to the preparation of financial statements. For example, while the SEC's financial reporting requirements and the Internal Revenue Code are directly related to the preparation of the financial statements rules relating for example to the disclosure of code of ethics or an audit committee financial expert are not directly related.

It should also be noted that the COSO framework includes "internal control over safeguarding of assets against unauthorized acquisition, use or disposition." The SEC notes that the purpose of the third bullet point of the definition of internal control over financial reporting (set forth above) is to ensure that this element of the COSO framework is captured in the SEC definition.

### III. Management's Annual Assessment of, and Report on, the Company's Internal Control over Financial Reporting

New Item 308 of Regulations S-K requires a company's annual report (including transition reports on Form 10-K, 20-F or 40-F) to include an internal control report of management that contains:

- 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 conduct the required evaluation of the effectiveness of the company's 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. The assessment must include disclosure of any "material weaknesses" in the company's internal control over financial reporting identified by management; and
- a statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the registrant's internal control over financial reporting.

Management may not qualify its conclusions with respect to the effectiveness of the company's internal control over financial reporting. Rather, management must take those problems into account when concluding whether the company's internal control over financial reporting is effective.

If a company reports the financial results of certain subsidiaries with different period-ends for financial reporting purposes, management's assessment of internal control over financial reporting may also be conducted and reported upon using those different period-ends.

The attestation (audit) report of the company's independent auditor must also be filed as part of the company's annual report. An independent auditor may combine its report on management's assessment on internal control with the audit report on the financial statements. However, in making its decision, an auditor should consider any issues that may arise if its audit report on the financial statements is expected to be reissued or incorporated by reference into a filing.

If a Form 10-K is incorporated into a filing made under the Securities Act of 1933, an auditor consent is required for the auditor's report on management's assessment of internal

control over financial reporting as well as the auditor's report on the financial statements. In addition, a new auditor consent is required in an amendment to the registration statement (i) whenever a change, other than a typographical error, is made to the financial statements and (ii) when facts are discovered that may impact the auditor's report on management's assessment of internal control over financial reporting.

If management's report on internal control over financial reporting does not identify a material weakness but the independent auditor's attestation report does, or vice versa, this would normally not be a disclosable event under Item 304 of Regulation S-K, unless the situation results in a change in auditor that would require disclosure under Item 304. However, differences in identification of material weaknesses could trigger other disclosure obligations.

If management or the independent auditor or both conclude that a company's internal control over financial reporting is not effective, the company would continue to be considered timely and current for purposes of the availability of Rule 144 and Forms S/F-2, S/F-3 and S-8 as long as the company's other reporting obligations are timely.

### ***Framework for Evaluating Internal Control over Financial Reporting***

Management is required to base its evaluation of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment. The SEC believes that the use of standard measures that are publicly available will enhance the quality of internal control reports and promote comparability of internal control reports of different companies. The internal control report must identify the evaluation framework used by management to assess the effectiveness of the company's internal control over financial reporting.

A suitable framework must:

- be free from bias;
- permit reasonably consistent qualitative and quantitative measurements 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 controls are not omitted; and
- be relevant to an evaluation of internal control over financial reporting.

The SEC indicated that the COSO framework satisfies these criteria. However, because the final rules do not mandate the use of a particular framework, issuers may use other frameworks so long as they also satisfy the above criteria. 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 are also suitable frameworks. Foreign private issuers using home country frameworks will be required to state affirmatively whether the controls are, or are not, effective, even though the home country framework may not require such a statement.

The COSO framework has five interrelated components, which form an integrated approach that can react to changing conditions. These components are built into an enterprise's infrastructure and are integral to the enterprise's operating activities. The essence of this framework is a process. The five components are:

- *control environment*, key elements of which are the composition of the board and audit committee, and how the directors fulfill their responsibilities relating to the financial reporting process, including assessing the reasonableness of management's accounting judgments and estimates and reviewing key SEC filings;
- *risk assessment*, which will vary depending upon the nature and breadth of operations of a particular business and involves assessments of both internal and external risks;
- *control activities*, which include policies and procedures, such as approvals, authorizations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties, that are designed to ensure that management directives are carried out;
- *information and communications*, which address (1) identification, capture and communication of pertinent information, both internally generated as well as information about external events, activities and conditions, necessary for management to make informed business decisions and for external reporting, and (2) effective communication both up and down the organization, so that personnel (a) understand their roles in internal controls as well as how their activities relate to the activities of others, (b) can effectively communicate information up the ladder, and (c) can effectively communicate with external parties such as customers, suppliers, regulators and shareholders; and
- *monitoring*, which involves ongoing monitoring in the course of operations, including management and supervisory activities, and separate evaluations.

***Standard Applicable to Management's Assessment of Effectiveness of Internal Control over Financial Reporting***

The proposing release did not include any specific standard on which management would base its conclusion that the company's internal control over financial reporting is effective. In response to a number of comments, the final rules preclude management from

determining that a company's internal control over financial reporting is effective if it identifies one or more "material weaknesses" in the company's internal control over financial reporting. Any such material weakness must also be specifically disclosed in the internal control report.

The term "material weakness" is defined in Auditing Standard No. 2 as "a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement in the company's annual or interim financial statements will not be prevented or detected." The SEC notes that a "material weakness" constitutes a greater deficiency than a "significant deficiency," but that an aggregation of significant deficiencies could constitute a material weakness in a company's internal control over financial reporting.

Auditing Standard No. 2 defines "significant deficiency" as "a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected."

It should be noted that the existence or nature of a significant deficiency is not required to be disclosed publicly. However, if the combination of significant deficiencies were to rise to the level of a material weakness, the material weakness must be disclosed and, if material to the understanding of the material weakness, the company should consider whether the nature of the significant deficiencies must also be disclosed.

### ***Method of Evaluating Internal Control over Financial Reporting***

According to the SEC, the methods of conducting evaluations of internal control over financial reporting will, and should, vary from company to company. Therefore, the rules do not specify the method or procedures to be performed in an evaluation. However, the assessment of a company's internal control over financial reporting must be based on procedures sufficient both to evaluate its design and to test its operating effectiveness. Controls subject to such assessment include, but are not limited to:

- controls over initiating, recording, processing and reconciling account balances, classes of transactions and disclosure and related assertions included in the financial statements;
- controls related to the initiation and processing of non-routine and non-systematic transactions;
- controls related to the selection and application of appropriate accounting policies; and

- controls related to the prevention, identification, and detection of fraud.

The nature of a company's testing activities will largely depend on the circumstances of the company and the significance of the control. However, the SEC indicates that inquiry alone generally will not provide an adequate basis for management's assessment.

### ***Document Retention***

In conducting its evaluation and developing its assessment of the effectiveness of internal control over financial reporting, a company must maintain evidential matter, including documentation, regarding both the design of internal controls and the testing processes to provide reasonable support for management's assessment of the effectiveness of internal control over financial reporting. This evidential matter should provide 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.

The SEC contends that developing and maintaining such evidential matter is an inherent element of effective internal control over financial reporting. An instruction to new Item 308 of Regulations S-K and Forms 20-F and 40-F reminds reporting companies to maintain such evidential matter. A company's independent auditor, which is required to attest to, and report on, management's assessment of the effectiveness of the company's internal control over financial reporting, also will require that the company develop and maintain such evidential matter to support management's assessment.

### ***Auditor Independence Issues***

Because of the independent auditor attestation requirement, management and the company's independent auditors will need to coordinate their processes of documenting and testing the internal control over financial reporting. The SEC reminds companies that:

- the SEC's rules on auditor independence prohibit an auditor from providing non-audit services to an audit client; and
- management cannot delegate its responsibilities to assess its internal controls over financial reporting to its independent auditors.

The auditor can assist management in documenting internal controls, provided management is actively involved in the process. Management cannot outsource the internal

control activities to its auditor, nor, in view of the auditor independence rules, can management accept responsibility for documentation and testing performed by the auditor.

#### ***Location of Management's Report***

The rules do not specify where management's internal control report is to appear within a company's annual report. However, in the adopting release, the SEC stated that the report should be in close proximity to the corresponding audit report issued by the company's independent auditor. The SEC expects that many companies will choose to place the internal control report and audit report near the MD&A or immediately preceding the companies' financial statements.

#### ***Inclusion of Management's Report and Auditor's Report in Proxy Materials***

The SEC has indicated that it believes the intent of Section 404 of the Act is that a company's audited financial statements with an accompanying audit report that are contained in or accompany a proxy statement or consent solicitation should also be accompanied by management's report on internal control over financial reporting and the auditor's report on management's assessment of internal control over financial reporting. The SEC intends to recommend amendments to Rules 14a-3 and 14c-3(a) and Item 13 of Schedule 14A to include this requirement and "encourages" companies to include these reports in the annual report to shareholders when their audited financial statements are included.

Companies must consider whether an annual report to shareholders contains a material omission if management states that internal control over financial reporting is ineffective or the auditor cannot deliver an unqualified report, and such reports are not contained in the annual report to shareholders.

#### **IV. Quarterly Evaluations of Internal Control over Financial Reporting**

The proposed rules would have required the certifying officers to evaluate the effectiveness of internal controls and procedures as of the end of each fiscal quarter. However, in response to numerous comments, the SEC decided not to require quarterly evaluations of internal control over financial reporting that are as extensive as the annual evaluation.

The final rules require management to evaluate any changes in the company's internal control over financial reporting that occurred during a fiscal quarter that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting. The company will also have to disclose any such changes in its quarterly report. The required disclosure is set forth in new Item 308 of Regulation S-K, which replaces the paragraph in existing Item 307 of Regulation S-K regarding quarterly disclosures of changes in internal controls. This disclosure would encompass a change (including an improvement) to internal control over financial reporting that was not necessarily in response to an identified significant deficiency or material weakness (for

example, the implementation of a new information system) if it materially affects the company's internal control. The SEC staff has indicated that if material to the understanding of a change made in response to a material weakness or significant deficiency, the company should consider whether the nature of the material weakness or the significant deficiency must also be disclosed in order to render the disclosure not misleading.

Management should determine materiality in line with the materiality standard applied by the courts in *TSC Industries, Inc. v. Northway, Inc.* 426 U.S. 438 (1976) and *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), which means that in evaluating whether a change to the company's internal control over financial reporting is material, the question is whether there is a substantial likelihood that a reasonable investor would view the change as significantly altering the total mix of information made available to it about the company.

The rules do not specify the point at which management must evaluate changes to the company's internal control over financial reporting. In the adopting release, the SEC indicated that as the final rules do not require a company to state the conclusions of the certifying officers regarding the effectiveness of the company's internal control over financial reporting as of a particular date on a quarterly basis, it was unnecessary to specify a date for the quarterly evaluation of changes in internal control over financial reporting. Management should perform evaluations of the design and operation of the entire system of internal control over a period of time that is adequate for it to determine whether, as of the end of the fiscal year, the design and operation are effective.

Because foreign private issuers are not required to file quarterly reports, the final rules clarify that management of a foreign private issuer need only disclose in the issuer's annual report any change to its internal control over financial reporting that occurred in the period covered by the annual report that materially affected, or is reasonably likely to materially affect, internal control over financial reporting.

The SEC staff has indicated that it would welcome, but does not require, a company to disclose changes or improvements to controls made as a result of preparing for the company's first management report on internal control over financial reporting. However, if the company were to identify a material weakness, it should carefully consider whether that fact should be disclosed, as well as changes made in response to the material weakness.

#### **V. Differences Between Internal Control over Financial Reporting and Disclosure Controls and Procedures**

The SEC recognized that there was significant confusion as to the differences between a company's disclosure controls and procedures and a company's internal control over financial reporting. "Disclosure controls and procedures" are defined as controls and other procedures of a company that are designed to ensure that information required to be disclosed by the company in the reports filed or submitted by it under the Exchange Act is

recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms.

While the SEC recognizes that there is substantial overlap between a company's disclosure controls and procedures and its internal control over financial reporting, there are some elements of disclosure controls and procedures that are not subsumed by internal control over financial reporting and some elements of internal control over financial reporting that are not subsumed by disclosure controls and procedures. The SEC believes that disclosure controls and procedures will include those components of internal control over financial reporting that provide reasonable assurances that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP. However, in designing their disclosure controls and procedures, companies can be expected to make judgments regarding the processes on which they will rely to meet applicable requirements. In doing so, some companies might design their disclosure controls and procedures so that certain components of internal control over financial reporting pertaining to the accurate recording of transactions and dispositions of assets or the safeguarding of assets are not included. For example, a company might have developed internal control over financial reporting that includes as a component of safeguarding of assets a dual signature requirement or limitation on signature authority on checks. That company could nonetheless determine that this component is not part of disclosure controls and procedures. Therefore, the SEC believes that many companies will design their disclosure controls and procedures so that they do not include all components of internal control over financial reporting.

## **VI. Section 302 and 906 Certifications**

The SEC also adopted amendments to require companies to file the certifications mandated by Sections 302 and 906 of the Act as exhibits to annual, semi-annual and quarterly reports. This change is intended to enhance access to the certifications by making them easier to locate and retrieve in the SEC's EDGAR system. Accordingly, the Section 302 certification will no longer be embedded in the body of the Exchange Act report, but instead filed as an exhibit. These certifications will be filed as exhibits 31 and 32, once the EDGAR system has been updated to accommodate these filings; in the meantime, they should be filed as exhibit 99. Section 906 certifications will be deemed "furnished," and not "filed," for liability purposes.

In connection with the amendments to Item 307 of Regulation S-K and the adoption of Item 308 of Regulation S-K, a number of changes have been made to the text of the Section 302 certification. The changes not only 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. Similar changes are being made to corresponding rules and form requirements that address annual and quarterly disclosures as to management's assessment of disclosure controls and procedures and internal control over financial reporting.

The Section 302 certification and corresponding disclosure requirements are modified as follows:

- to incorporate the term “internal control over financial reporting” into the certification
- to add a statement that the principal executive and financial officers are responsible for designing internal control over financial reporting or having such control designed under their supervision;
- to clarify that disclosure controls and procedures may be designed under the supervision of the principal executive and financial officers;
- to require that the statement as to the effectiveness of disclosure controls and procedures be as of the end of the relevant period; and
- to amend the provision of the certification relating to changes in internal control over financial reporting, consistent with the final rules discussed above regarding evaluation and disclosure, so that it refers to changes that have materially affected or are reasonably likely to materially affect internal control over financial reporting.

A copy of the amended Section 302 certification is attached to this memorandum as Annex A.

## **VII. Application of Final Rules to Particular Types of Issuers**

### **A. Asset-Backed Securities Issuers**

Because of the nature of asset-backed issuers, the SEC has in the past granted requests allowing asset-backed issuers to file modified reports under the Exchange Act. Asset-backed issuers are allowed to file modified annual reports on Form 10-K and to file reports on Form 8-K tied to payments on the underlying assets in the trust. Because the information included in these reports for asset-backed issuers differs significantly from that provided by other issuers, as well as the structure of asset-backed issuers, the SEC exempted them from the final rules.

### **B. Investment Companies**

Section 404 of the Act does not apply to registered investment companies, and the SEC did not propose to extend any of the requirements that would implement Section 404 to registered investment companies. The SEC did, however, make technical changes to its rules implementing Section 302 of the Act for registered investment companies, principally to conform to the rule changes for operating companies.

### **C. Bank and thrift holding companies**

Bank and thrift holding companies are already required to file internal control reports with the FDIC. The SEC stated that companies subject to internal control requirements of both Section 404 and the FDIC's rules may choose to either:

- prepare two separate management reports to satisfy the FDIC's and the SEC's new requirements; or
- prepare a single management report that satisfies both the FDIC's requirements and the SEC's new requirements.

## **VIII. Application of Final Rules in Certain Specific Circumstances**

In the FAQ, the SEC staff has provided guidance with respect to the interpretation and application by the staff of the final rules in certain specific circumstances as set forth below.

### **A. Certain Consolidated Entities (FIN 46 and EITF 00-1)**

A reporting company's internal control over financial reporting is expected to cover all consolidated entities, irrespective of the basis for consolidation. However, in situations where a reporting company does not have the right or authority to assess the internal controls of the consolidated entity and also lacks the ability, in practice, to make that assessment (for example, in the case of entities consolidated pursuant to FIN 46 or accounted via proportionate consolidation in accordance with EITF 00-1), the company should provide disclosure in its Form 10-K, 20-F or 40-F to the effect that management has been unable to assess the effectiveness of internal control at those entities. The company should also disclose key sub-totals (such as total and net assets, revenues and net income) for consolidated entities whose internal control have not been assessed.

### **B. Equity Method Investments**

A reporting company's internal control over financial reporting is not expected to cover entities accounted for as an equity method investment. However, the company must have controls over the recording of amounts related to its investments that are recorded in the consolidated financial statements. Accordingly, a company would have to consider, among other things, the controls over: the selection of accounting methods for its investments, the recognition of equity method earnings and losses, its investment account balance. The SEC staff has indicated that for purposes of applying this guidance, it makes no distinction between those equity method investments for which a company is required to file audited financial statements pursuant to Rule 3-09 of Regulation S-X and those where no such requirement is triggered.

### C. Acquired Businesses

Management may omit an assessment of the internal control over financial reporting of an acquired business<sup>1</sup> for up to one year from the date of acquisition or one annual management report on internal control over financial reporting, whichever is sooner, if it is not possible to conduct an assessment of the internal control of the acquired business between the date of the acquisition and the date of management's assessment. In such instances, the company should provide disclosure in its Form 10-K, 20-F or 40-F to the effect that management excluded the acquired business from its report on internal control over financial reporting. Disclosure must also identify the acquired business being excluded and indicate its significance to the company's consolidated financial statements. Notwithstanding exclusion of an acquired business's internal controls, a company must disclose any material change to its internal control over financial reporting due to the acquisition, as required by Rules 13a-15(d) or 15d-15(d) and Regulation S-K, Item 308.

### D. Outsourced Activities

If a company outsourced certain functions to third party service providers (for example, payroll or information technology), management retains responsibility to assess the controls over the outsourced operations. However, management may rely on a Type 2 SAS 70 report<sup>2</sup> performed by the independent auditors of the third party service provider even if the auditors for both companies were the same or if the reports are as of a different year-end. However, management may not rely on a Type 2 SAS 70 report if it engaged the company's independent audit firm to also prepare such report on the third party service provider. In addition, the SEC in the October FAQ reiterated that a company may not limit the scope of its assessment of internal control over financial reporting even if management has outsourced a significant process to a service organization and the service organization is unwilling to provide a Type 2 SAS 70 report or access to assess the controls in place at the service organization.

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<sup>1</sup> The term "business" includes those acquisitions that would constitute a business based upon the facts and circumstances as outlined in Article 11-01(a) of Regulation S-X.

<sup>2</sup> This report is a service auditor's report on a service organization's description of controls as to whether such controls were suitably designed to achieve specific control objectives, whether they had been placed in operation as of a specific date and whether the controls that were tested were operating with sufficient effectiveness to provide reasonable, but not absolute, assurance that the related control objectives were achieved during the period specified.

## **IX. Transition Periods on Effective Date of New Rules**

### ***Rules Relating to Internal Control Reports***

A company that is an “accelerated filer,” as of the end of its first fiscal year ending on or after November 15, 2004, must begin to comply with the internal control report disclosure requirements in its annual report for that fiscal year. A company that is not an accelerated filer as of the end of its first fiscal year ending on or after November 15, 2004, including foreign private issuers, must begin to comply with the internal control report disclosure requirements for its first fiscal year ending on or after July 15, 2005. When filing a transition report, these provisions should be applied to the transition period as if it were a fiscal year.

A company must determine whether it is an “accelerated filer” at the end of its fiscal year, based on the market value of the public float of its common shares as of the last business day of its most recently completed second fiscal quarter.

### ***Rules Relating to Quarterly Evaluations***

The requirements regarding evaluation of material changes to a company’s internal control over financial reporting are applicable for a company’s first periodic report due after the first annual report that is required to include an internal control report.

### ***Changes to Section 302 Certification and Corresponding Disclosure Requirements***

A company must comply with the new exhibit requirements for the certifications required by Section 302 and 906 of the Act and changes to the Section 302 certification requirements in its first quarterly, semi-annual or annual report due on or after August 14, 2003. To account for the differences between the compliance date of the rules relating to internal control over financial reporting and the effective date of changes to the language of the Section 302 certification, a company’s certifying officers may temporarily modify the content of their Section 302 certification to eliminate certain references to internal control over financial reporting until the compliance dates discussed above.

Specifically, until such compliance date, as indicated in Annex A, companies may omit the following from the Section 302 certification:

- the portion of the introductory language in paragraph 4 of the Section 302 certification that refers to the certifying officers’ responsibility for establishing and maintaining internal control over financial reporting for the company; and
- paragraph 4(b), which must be provided in the first annual report required to contain management's internal control report and thereafter.

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This memorandum is not intended to provide legal advice with respect to any particular situation and no legal or business decision should be based solely on its content. Questions concerning issues addressed in this memorandum should be directed to any member of the Paul Weiss Securities Group, including:

Mark S. Bergman	(44 20) 7367-1601	John C. Kennedy	(212) 373-3025
Richard S. Borisoff	(212) 373-3153	Edwin S. Maynard	(212) 373-3034
Andrew J. Foley	(212) 373-3078	Raphael M. Russo	(212) 373-3309
Paul D. Ginsberg	(212) 373-3131	Gábor Molnár	(44 20) 7367-1605

**PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP**

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**Annex A – Revised Section 302 certification (portions in bold may be omitted until such time as the registrant is required to comply with the final 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 controls over financial reporting.

Date: .....

\_\_\_\_\_

[Signature]

[Title]

\* Provide a separate certification for each principal executive officer and principal financial officer of the registrant. See Rules 13a-14(a) and 15d-14(a).