

October 25, 2002

SEC Proposes Rules Regarding Internal Controls and Procedures for Financial Reporting

The SEC has proposed new rules regarding internal controls and procedures for financial reporting. These internal controls pertain to the preparation of financial statements for external purposes that are fairly presented in conformity with generally accepted accounting principles. They are distinguished from “disclosure controls and procedures,” the subject of other recent SEC rulemaking, which are intended to ensure that information required to be disclosed by the issuer in 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.

I. Overview

The proposed rules would implement Section 404 of the Sarbanes-Oxley Act of 2002 (the “Act”). The rules would require inclusion of an annual internal control report of management in all 10-Ks, 20-Fs and 40-Fs. The report would be required to include:

- a statement of management’s responsibilities for establishing and maintaining adequate internal controls and procedures for financial reporting;
- management’s conclusions about the effectiveness of the company’s internal controls and procedures for financial reporting based on an evaluation of those controls and procedures;
- a statement that the company’s registered public accounting firm has attested to, and reported on, management’s evaluation of the company’s internal controls and procedures for financial reporting; and
- the attestation report of the company’s registered public accounting firm.

In addition, proposed amendments to Rules 13a-15 and 15d-15 and to Item 307 of Regulation S-K would require:

- that management, with the participation of the CEO and CFO, evaluate the company’s internal controls and procedures for financial reporting as of the end of each quarter; and
- that the CEO and CFO include their conclusions regarding the effectiveness of the company’s internal controls and procedures for financial reporting in each quarterly and annual report.

The rules implementing Section 302 of the Act, which the SEC adopted in a rulemaking release in August 2002 (the “August Release”), require a quarterly evaluation and disclosure of conclusions regarding the effectiveness of the company’s “disclosure controls and procedures.”

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The August Release also requires quarterly disclosure of changes to internal controls and procedures. Both of these requirements remain, but are proposed to be amended so that an evaluation of both disclosure controls and internal controls will be made as of the end of the period covered by the report (as opposed to within 90 days prior to filing the report).

Similarly, the certification requirements adopted in the August Release are proposed to be expanded to include additional certifications reflecting management's responsibility for the design, maintenance and periodic evaluation of internal controls and procedures for financial reporting.

The requirements of the new rules would apply to all reporting companies, both U.S. and non-U.S.

The new rules and amendments described in this memorandum are proposed to take effect for annual reports for fiscal years ending on or after September 15, 2003.

II. Background

A. 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 responsibilities 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.

B. Rules Adopted under Section 302 of the Act

In the August Release, the SEC adopted new Exchange Act Rules 13a-14 and 15d-14 to implement Section 302 of the Act. These rules require the principal executive and financial officers of reporting companies to make certifications in their companies' quarterly and annual reports regarding both "disclosure controls and procedures" and "internal controls." "Disclosure controls and procedures" are distinguished from internal controls and procedures for financial reporting and are defined as controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer 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.

Of relevance to the new proposed rules and amendments are requirements in the August Release that each quarterly and annual report contain a statement by the CEO and CFO that they:

- are responsible for establishing and maintaining “*disclosure controls and procedures*” for the issuer;
- have designed such *disclosure controls and procedures* to ensure that material information is made known to them, particularly during the period in which the periodic report is being prepared;
- have evaluated the effectiveness of the issuer’s *disclosure controls and procedures* as of a date within 90 days prior to the filing date of the report;
- have presented in the report their conclusions about the effectiveness of the *disclosure controls and procedures* based on the required evaluation as of that date;
- have disclosed to auditors and the audit committee:
 - all significant deficiencies and material weaknesses in the design or operation of *internal controls* (a pre-existing term relating to internal controls regarding financial reporting) which could adversely affect the issuer’s ability to record, process, summarize and report financial data and have identified for the issuer’s auditors any material weaknesses in *internal controls*; and
 - any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer’s *internal controls*; and
- have indicated in the report whether or not there were significant changes in *internal controls* or in other factors that could significantly affect *internal controls* subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

At the same time, the SEC also adopted new Item 307 of Regulation S-K to require disclosure in the company’s annual and quarterly reports about the principal officers’ evaluation of the company’s *disclosure controls and procedures* and whether or not there have been significant changes to the company’s *internal controls*.

III. Internal Controls and Procedures for Financial Reporting

Although 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, the SEC has come to the realization that there are a variety of different definitions of the term “internal controls” and that its meaning has changed over time.

Therefore, to clarify the meaning of the term, the SEC has proposed amending Rule 13a-14 and 15d-14 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 (“AU Section 319”) or in any superseding definition or other literature that is adopted by the PCAOB. ‘

According to the SEC, the purpose of internal controls and procedures for financial reporting is to ensure that companies have processes designed to provide reasonable assurance that:

- the company's transactions are properly authorized;
- the company's assets are safeguarded against unauthorized or improper use; and
- the company's transactions are properly recorded and reported to permit the preparation of the registrant's financial statements in conformity with generally accepted accounting principles.

AU Section 319 describes five interrelated components that constitute "internal controls":

- the *control environment*, which includes the participation of management and the assignment of authority and responsibility within the company's organizational structure. The control environment sets the tone of an organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control providing discipline and structure;
- *risk assessment*, the company's identification and analysis of relevant risks to achievement of its financial reporting objective, such as changes in personnel, technology, operating environment and accounting standards. The assessment forms a basis for determining how the risks should be managed;
- *control activities*, which are the policies and procedures that help ensure that management directives are carried out. Control activities include performance reviews, information processing, physical controls and the segregation of duties among personnel;
- *information and communication systems* that support the identification, capture and exchange of information in a form and time frame that enable management to prepare reliable financial reports; and
- *monitoring* to assesses the design and operation of internal controls in a timely manner through both ongoing activities and separate evaluations.

IV. Quarterly Evaluation of Internal Controls and Procedures for Financial Reporting and Report

Although Section 404 of the Act contemplates only an annual evaluation of the company's internal controls, as noted above, a company's officers already must certify quarterly to significant changes to internal controls as required by Section 302 of the Act. The rules adopted in the August Release also require the company's principal executive and financial officers to disclose "any significant changes in the company's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with respect to significant deficiencies and material weaknesses." Despite the reference to an evaluation of internal controls in this disclosure requirement, the rules adopted in the August Release require a company to conduct a quarterly evaluation of the company's disclosure controls and procedures but do not require an evaluation of internal controls.

To provide a basis for the quarterly disclosure about changes to the company's internal controls and procedures for financial reporting, and to create symmetry between the requirements for periodic evaluations of both the company's disclosure controls and procedures and its internal controls and procedures for financial reporting, the SEC has now proposed a requirement in

Exchange Act Rules 13a-15 and 15d-15 that the company's management evaluate the effectiveness of the design and operation of the company's internal controls and procedures for financial reporting, as well as its disclosure controls and procedures, with respect to each annual and quarterly report that it is required to file under the Exchange Act.

The SEC proposes to clarify the rules to make clear that the required evaluations are to be conducted by management, with the participation of the CEO and CFO.

As was the case with the rules calling for an evaluation of disclosure controls and procedures, the new rules do not provide detailed procedures for the evaluation of internal controls and procedures for financial reporting. The evaluation must, at a minimum, address the matters specified by the disclosure requirements.

In addition, the SEC's proposed rules would modify the requirement adopted in the August Release that the evaluation be conducted within the 90-day period prior to the filing date of the quarterly or annual report, to require that both the disclosure controls and internal controls evaluations be made as of the end of the period covered by the report.

V. Annual Internal Control Report

The SEC's proposed amendments to Item 307 of Regulations S-K, as well as Forms 10-K, 20-F and 40-F, would require a company's annual report to include an internal control report of management that includes:

- a statement of management's responsibilities for establishing and maintaining adequate internal controls and procedures for financial reporting;
- conclusions about the effectiveness of the company's internal controls and procedures for financial reporting based on management's evaluation of those controls and procedures in accordance with Exchange Act Rule 13a-15 or 15d-15, as of the end of the company's most recent fiscal year;
- a statement that the registered public accounting firm that prepared or issued the company's audit report relating to the financial statements included in the company's annual report has attested to, and reported on, management's evaluation of the company's internal controls and procedures for financial reporting; and
- the attestation report of the registered public accounting firm that audited or reviewed the financial statements included in the annual report.

The proposed amendments do not specify the exact content of the proposed management internal control report, in the hope that doing so would avoid boilerplate responses of little value. Rather, the SEC believes that management should tailor the report to the company's circumstances.

Regulation S-X is also proposed to be amended to reflect the requirement that every registered accounting firm that prepares an audit report must also examine, attest to and report separately on the effectiveness of the company's internal controls and procedures for financial reporting. The attestation must be dated and manually signed, identify the period covered and clearly state the opinion of the accountant as to whether the company's disclosure about the effectiveness of its internal controls and procedures for financial reporting is fairly stated in all

material respects, or must include an opinion to the effect that an overall opinion cannot be expressed together with an explanation of why an overall opinion cannot be expressed.

The internal control report disclosure is in addition to the disclosure mandated by the August Release regarding changes in internal controls and procedures during the period covered by the report, including actions to correct deficiencies and weaknesses in the controls and procedures.

VI. Certifications as to Internal Controls and Procedures for Financial Reporting

The SEC has proposed expanding the certification requirements adopted in the August Release to include additional certifications regarding internal controls and procedures for financial reporting. If amended as proposed, annual and quarterly reports would contain additional certifications that the certifying officers:

- are responsible for establishing and maintaining internal controls and procedures for financial reporting;
- have designed (or caused to be designed) internal controls and procedures for financial reporting to provide reasonable assurances that the registrant's financial statements are fairly presented in conformity with generally accepted accounting principles;
- have evaluated the effectiveness of the company's internal controls and procedures for financial reporting as of the end of the period covered by the report;
- have presented in the report their conclusions about the effectiveness of the company's internal controls and procedures for financial reporting; and
- have identified any material weaknesses in the design or operation of the company's internal controls and procedures for financial reporting to the company's auditors and audit committee.

A complete form of certification, including the proposed changes outlined above, is attached as Exhibit A.

The SEC has proposed modifications to the certifications to make clear that the certifying officers need not personally design either disclosure controls and procedures or internal controls and procedures. Rather, the procedures may be designed by others, provided the certifying officers have "supervised" the design of such procedures.

VII. Application of New 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's proposed rules would exclude them from the disclosure requirements under proposed Item 307 of Regulation S-K.

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, propose to make technical changes to its rules implementing Section 302 of the Act for registered investment companies, principally to conform to the rule changes that are proposed 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 proposed SEC rules are similar to existing FDIC internal control report requirements, although the SEC's proposed rules differ in a few respects. The SEC has indicated that it is coordinating with the FDIC and other federal banking regulators to eliminate, to the extent possible, any unnecessary duplication between the SEC's proposed internal control report and the FDIC's internal control report requirements. The SEC said that it expects to provide further guidance on this subject in its release adopting final rules under Section 404 of the Act.

VIII. Proposed Effective Time of New Rules

Recognizing that companies and their auditors will require substantial time to develop processes under relevant standards and to train appropriate personnel to ensure compliance with the requirements imposed by Section 404 of the Act, and in light of the fact that companies and accounting firms will need additional time to actually perform these activities, the SEC has proposed that the rules under Section 404 of the Act, if adopted, would apply for fiscal years ending on or after September 15, 2003.

Similarly, the effective time of the proposed changes to the certifications contained in annual and quarterly reports will also be delayed until companies have had the opportunity to perform the comprehensive evaluation of internal controls and procedures for financial reporting contemplated by Section 404. Management need not provide the proposed amended certifications until the first annual report in which their companies include the internal control report required under Section 404. In the meantime, companies need only provide certifications as adopted in the August Release.

The SEC has indicated that companies may voluntarily provide an annual report on the effectiveness of its internal controls and procedures for financial reporting prior to the effective date. To do so, they should follow the existing accounting literature regarding internal controls. Similarly, to the extent attestations are made, accountants can perform them in conformity with existing accounting literature regarding attestation engagements, including Section 501 of the AICPA's Statement on Standards for Attestation Engagements.

IX. Rulemaking Process

The proposed rules and amendments are subject to a 30-day public comment period. The new rules and amendments described in this memorandum are proposed to take effect for annual reports for fiscal years ending on or after September 15, 2003.

One can expect that the proposed rules will be adopted substantially in the form proposed. It would be helpful, in view of the delayed effectiveness of the Section 404 provisions, if the SEC clarified how registrants should deal with the implied obligations under the currently effective certification requirements in respect of internal controls, and in particular how CEOs/CFOs are to certify as to the absence of changes since the last evaluation if no such evaluation has been mandated.

* * *

The recommendations set forth herein are intended to be general in nature. 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:

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Exhibit A - Proposed certification that would be required for fiscal years beginning on or after September 15, 2003 (new language in bold)

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

1. I have reviewed this [annual/quarterly] report on Form [10-K/ 20-F / 40-F / 10-Q] 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 officers and I are responsible for establishing and maintaining disclosure controls and procedures **and internal controls and procedures for financial reporting** (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we 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 issuer, 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 controls and procedures for financial reporting, or caused such internal controls and procedures for financial reporting to be designed under their supervision, to provide reasonable assurances that the registrant's financial statements are fairly presented in conformity with generally accepted accounting principles;**
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures **and internal controls and procedures for financial reporting as of the end of the period covered by this report ("Evaluation Date")**;
 - d) Presented in this report our conclusions about the effectiveness of the disclosure controls and procedures **and internal controls and procedures for financial reporting** based on our evaluation as of the Evaluation Date;
 - e) Disclosed to the registrant's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function):
 - (i) All significant deficiencies and material weaknesses in the design or operation of internal controls and procedures for financial reporting which could adversely affect the registrant's ability to record, process, summarize and report financial **information required to be disclosed by the registrant in the reports that it files or submits under the Act (15 U.S.C. 78a et seq.), within the time periods specified in the U.S. Securities and Exchange Commission's rules and forms;** and
 - (ii) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls and procedures for financial reporting; and
 - f) Indicated in this report any significant changes in the registrant's internal controls and procedures for financial reporting or in other factors that could significantly affect internal controls and procedures for financial reporting made during the period covered by this

report, including any actions taken to correct significant deficiencies and material weaknesses in the registrant's internal controls and procedures for 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 and 15d-14. The required certification must be in the exact form set forth above.