



# Financial Reporting

July 2003

## SEC Completes Mandated Sarbanes-Oxley Act Rulemaking

The Sarbanes-Oxley Act of 2002 (the Act) required the SEC to adopt rules to implement a number of its provisions. Although the SEC still has a number of related rulemaking proposals on its agenda, the Commission recently completed all of the rulemaking mandated by the Act. This letter covers three of those recent rulemaking activities.

In what many believe is the most significant of all the rulemaking driven by the Act, the SEC adopted rules that will require companies to report annually on the effectiveness of their internal controls and require auditors to attest to management's assessment. Although this requirement will not take effect until 2004 at the earliest, it will require a significant amount of effort, so companies that have not already done so should begin their compliance efforts immediately. In addition, certain aspects of the rules covering certifications in periodic reports were changed, and these changes affect these reports now.

The Commission also adopted rules that direct the national securities exchanges and associations to prohibit the listing of the securities of an issuer that is not in compliance with the standards for audit committees as set forth in the Act. These rules, together with rules to be adopted by the exchanges, set minimum standards for the independence of audit committee members and require audit committees to be directly responsible for the appointment, compensation, retention, and oversight of the work of a company's auditors.

In addition, the Commission adopted rules prohibiting an officer or director of an issuer, or any other person acting under the direction thereof, from improperly influencing the issuer's auditor. Much of the misconduct addressed by the new rules generally would be subject to other provisions of the securities laws and the Commission's regulations.

### Internal Control Reporting

The Commission adopted new rules that implement Section 404 of the Act, which requires the SEC to adopt rules requiring management to evaluate and report on the effectiveness of a company's internal controls in each annual report. Section 404 also requires a company to engage its auditor to examine management's evaluation and provide an auditor's attestation report in each annual report. These new rules, which are outlined in Release 33-8238, require the following:

- Management to report on a company's internal controls in each annual report;
- A company's auditors to issue a report attesting to management's annual assessment of the company's internal controls;
- Management to disclose, each quarter, material changes *during the quarter* in internal controls (this is a modification of the previous requirement for management to

### Contents

Internal Control Reporting	1
Listed Company Audit Committees	7
Improper Influence on Conduct of Audits	11
For Further Information	12
The SEC's Releases	12

disclose significant changes in internal controls that occurred *subsequent to* the date of their evaluation);

- Management to evaluate and report on the company's disclosure controls and procedures *as of the end of each quarter* (this is a modification of the previous requirement for management to perform this evaluation as of a date within 90 days of the filing date of each periodic report);
- Wording changes to the Section 302 certifications to conform them to the revised controls evaluation and reporting requirements;
- Section 302 certifications to be filed as exhibits (previously, these certifications were provided immediately after the signatures in periodic reports); and
- Section 906 certifications to be furnished as exhibits (previously, there were no rules specifying how these certifications were to be provided, and they were provided in a variety of ways).

In response to the many comments the SEC received on its October 2002 proposal, the final rules reflect several changes. Some of the more significant changes are:

- *Delayed effective date* – In recognition of the considerable amount of work required to implement the rules, for most companies they will take effect at a later date than had been proposed. The SEC had proposed that the requirements for a management report on internal control and an auditor attestation report would apply to calendar year companies in their 2003 annual reports. The final rules will require large domestic calendar year companies to provide these reports in their 2004 annual reports and other companies to provide them in their 2005 annual reports.

- *Definition clarified* – The internal controls covered by the rules have been defined in a manner that more closely follows the definition used by the Committee of Sponsoring Organizations of the Treadway Commission in its 1992 report (the COSO Report). The final rules use the term "internal control over financial reporting." This new term is defined to include controls that pertain to maintenance of records, recording of transactions, and safeguarding of assets. Controls pertaining to efficiency of operations and compliance with laws are not included in the definition of internal control over financial reporting.

- *Established framework required* – The final rules require management to make its internal control evaluation using a suitable, recognized control framework that has been established by a body or group that followed due process procedures in establishing the framework. In addition, the report on internal controls must identify the framework used.

- *Less quarterly evaluation work required* – The proposed rules suggested that a full evaluation and management report on internal control would be required each quarter. The final rules do not require a quarterly report. They require only that management evaluate any changes in internal control that occurred during the quarter (including the fourth quarter) and disclose those changes that have materially affected or are reasonably likely to materially affect the company's internal control over financial reporting.

The rules apply to companies that file reports pursuant to Section 13(a) or 15(d) of the Exchange Act. Accordingly, the rules apply to small

business issuers and foreign private issuers. Although registered investment companies (other than small business investment companies) are subject to new rules requiring them to maintain internal control over financial reporting, they are not subject to the new internal control evaluation and reporting requirements.

The new rules are reflected in amendments to:

- The following Exchange Act periodic report forms: Forms 10-K, 10-KSB, 20-F, 40-F, 10-Q, and 10-QSB (but not Form 11-K);
- Regulations S-K and S-B (Item 307 was amended, a new Item 308 was created, and new exhibits were added to Item 601);
- Exchange Act rules, principally Rules 13a-14, 13a-15, 15d-14, and 15d-15; and
- Investment Company Act rules and Form N-CSR.

In the amendments to Forms 10-K and 10-KSB, the Commission redesignated Item 14, Controls and Procedures, as new Item 9A of Form 10-K and Item 8A of Form 10-KSB.

## Evaluation and Reporting Requirements

New Exchange Act Rules 13a-15(c) and 15d-15(c) require the management of each issuer, other than a registered investment company, to evaluate, with the participation of the issuer's principal executive and financial officers, the effectiveness of the issuer's internal control over financial reporting as of the end of each fiscal year. The evaluations must be based on a framework that is a suitable, recognized control framework that has been established by a body or group that has followed due process procedures, including a broad distribution of the framework for public comment. The COSO framework will satisfy the SEC's criteria. However, the final

rules do not mandate the use of a particular framework.

New Exchange Act Rules 13a-15(d) and 15d-15(d) require management to evaluate any change in the issuer's internal control over financial reporting that occurred during each fiscal quarter (including the fourth quarter) that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting. Foreign private issuers need to perform this evaluation only on an annual basis.

The rules do not specify the methods for or procedures to be performed in evaluating internal control over financial reporting. However, the new rules state that in conducting the evaluation and developing an assessment of the effectiveness of internal controls, a company must maintain evidential matter, including documentation, to provide reasonable support for management's conclusions. In addition, the release states that inquiry alone will not provide an adequate basis for management's assessment. The assessment must be based on procedures sufficient to both:

- Evaluate the design of the controls and
- Test their operating effectiveness.

While non-management personnel may perform this work, management must actively supervise the entire process.

The SEC's independence rules prohibit a company from relying on its auditors to perform the evaluation of the effectiveness of internal controls. However, an auditor may assist its client in many ways with the work required to comply with the rules. For example, auditors may:

- Assist management in documenting internal controls;
- Provide software templates to help document controls or perform statistical sampling;

- Note areas where management might wish to improve controls; and

- Make suggestions to improve tests of controls.

However, it is management who must perform the evaluation. Management must:

- Perform the evaluation and testing;
- Exercise its own judgment in performing the analysis;
- Make all final decisions; and
- Be "in charge" of the work being done.

Amendments to Forms 10-K and 10-KSB require companies to include in their annual reports a report of management on the company's internal control over financial reporting. The requirements for this report are outlined in new Item 308 of Regulations S-K and S-B. New companion rules in Forms 20-F and 40-F contain the same requirements. The report must include:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting;
- A statement identifying the framework used by management to evaluate the effectiveness of the 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; and
- A statement that the registered public accounting firm that audited the company's financial statements has issued an attestation report on management's assessment of the company's internal control over financial reporting.

With regard to management's assessment of the effectiveness of the company's internal controls:

- A negative assurance statement indicating that nothing has come to management's attention to suggest that the company's internal control over financial reporting is not effective will not be acceptable;
- The report must include disclosure of any material weaknesses in the company's internal control over financial reporting;
- Management is not permitted to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses;
- It is the Commission's judgment that an aggregation of significant deficiencies could constitute a material weakness.

The rules do not specify where the internal control report must appear in the company's annual report. However, the SEC expects that companies will choose to place the report near the MD&A disclosure or in a portion of the document immediately preceding the financial statements.

New Item 308(c) of Regulations S-K and S-B requires disclosure of material changes in internal control over financial reporting that have occurred during a quarter (including the fourth quarter). However, the rules do not require a quarterly report on the effectiveness of a company's internal controls.

New Item 308(b) of Regulations S-K and S-B (and related Items in Forms 20-F and 40-F) requires a company to file the registered public accounting firm's attestation report on management's assessment of the company's internal controls as part of the annual report. Section 404 of the Act stipulates that the attestation cannot be the sub-

ject of a separate engagement. Accordingly, new Rule 2-02(f) of Regulation S-X requires auditors who issue a report on a registrant's financial statements included in an annual report to also issue a report attesting to management's assertion regarding the internal controls. The rule also specifies the technical requirements for the auditor's attestation report. The attestation report may be separate from the accountant's report.

The attestation standards auditors must follow are those adopted in April 2003 by the Public Company Accounting Oversight Board (PCAOB) on a transitional basis. Those standards are contained in Section AT 501 of the Codification of Statements on Standards for Attestation Engagements, *Reporting on an Entity's Internal Control Over Financial Reporting*.

**Observations** – *The PCAOB has made adopting a new standard covering these engagements a high priority, and it appears likely that new standards will be in place before auditors are required to perform these engagements.*

*Since auditing standards have not previously required auditors to evaluate internal controls to this extent, it is likely that this requirement will add substantial time to most audits.*

### **Definition of Internal Control Over Financial Reporting**

New Exchange Act Rules 13a-15(f) and 15d-15(f) define internal control over financial reporting as “a process designed by, or under the supervision of, the issuer's principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer's board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance

with generally accepted accounting principles and includes those policies and procedures that:

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

The definition is consistent with the description of internal accounting controls in Exchange Act Section 13(b)(2)(B).

The SEC's rules adopted in August 2002 to implement Section 302 of the Act require a company's principal executive and financial officers to certify on a quarterly basis as to their responsibility for establishing and maintaining disclosure controls and procedures and their evaluation of the effectiveness of those controls and procedures. Disclosure controls and procedures are defined as “controls and other procedures of an issuer that are designed to ensure that information required to be disclosed ... is recorded, processed, summarized and reported, within the time periods specified ...”

The SEC believes that there is substantial overlap between a com-

pany's disclosure controls and procedures and its internal control over financial reporting. The Commission also believes that there are elements of each definition that are not subsumed by the other. Disclosure controls and procedures cover a broader range of information than covered by a company's internal control over financial reporting. Therefore, some disclosure controls (e.g., those related to non-financial information included in public reports) would not be part of a company's internal control over financial reporting. Other disclosure controls and procedures, such as controls that provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, are also components of internal control over financial reporting. However, some of an issuer's internal controls that pertain to accurate recording of transactions and safeguarding of assets might not be part of a company's disclosure controls and procedures.

**Observations** – *Regarding the question of whether a control that is part of a company's internal control over financial reporting is also part of its disclosure controls and procedures, the release discusses examples of safeguarding controls such as requiring dual signatures on checks or limiting the signature authority on checks. It states that a company with such safeguarding controls could determine that those controls are not part of disclosure controls and procedures. Conversely, a safeguarding control that might also constitute an element of a company's disclosure controls and procedures might be physical security controls over inventory, which are discussed in footnote 57 in the release. If management relies on this safeguarding control to achieve financial reporting that is in accordance with GAAP, the control will also be an element of the company's disclosure controls and procedures.*

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## Applicability to Various Types of Issuers

**Small business issuers** – The rules apply to small business issuers. As discussed below, the Commission adopted a later compliance date for these issuers.

**Foreign private issuers** – The rules apply to foreign private issuers. As discussed below, the Commission also adopted a later compliance date for these issuers. In addition, foreign private issuers are not required to file quarterly reports. Therefore, the requirement to disclose changes in internal controls each quarter does not apply to them. These issuers need only disclose in the annual report the material changes to internal controls that have occurred during the period covered by the annual report.

**Asset-backed issuers** – The rules do not apply to issuers of asset-backed securities.

**Bank and thrift holding companies** – Such companies that are required to file reports under the Exchange Act are subject to the new internal control reporting requirements. However, since many bank and thrift holding companies file internal control reports with the FDIC, the rules give these companies the option of preparing a single management report that satisfies both the FDIC's and the SEC's requirements. The report must contain specific statements, which are listed in the release, that address both the SEC's and the FDIC's requirements. In addition:

- The company must provide the required auditor's attestation report and
- For purposes of the internal control report and the attestation report, financial reporting must

encompass both financial statements prepared in accordance with GAAP and those prepared for regulatory reporting purposes.

**Registered investment companies** – Section 404 of the Act does not apply to registered investment companies. However, the rules requiring a company's management to establish and maintain internal control over financial reporting do apply to registered investment companies (other than small business investment companies) beginning in fiscal years ending on or after June 15, 2004. The rules and forms that implement the Section 302 certifications for registered investment companies have been amended to conform to the amendments adopted for operating companies.

## Changes in Certification Requirements

The rules and forms implementing Section 302 certifications have been amended to conform those requirements with the changes outlined above. The changes are as follows:

- The officers must certify as to their responsibility for establishing and maintaining both disclosure controls and procedures *and* internal control over financial reporting.
- The officers must certify that they have designed the registrant's internal control over financial reporting (or caused such internal control over financial reporting to be designed under their supervision) to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP.
- The officers must certify that they have evaluated the effectiveness of the registrant's disclosure controls and procedures

and reported those conclusions *as of the end of the period* covered by the report. (This is a modification of the previous requirement for management to perform this evaluation as of a date within 90 days of the filing date of each periodic report. The evaluation date was not changed for registered investment companies.)

- The officers must certify that they have disclosed any change in the company's internal control over financial reporting that occurred *during the company's most recent fiscal quarter* that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting. (This is a modification of the previous requirement for officers to certify that they have disclosed significant changes in internal controls that occurred *subsequent to* the date of their evaluation.)

The SEC also adopted rules requiring companies (including foreign private issuers and investment companies) to provide the CEO and CFO certifications required by Sections 302 and 906 of the Act as exhibits to the periodic reports to which they relate. The amendments permit companies to "furnish" rather than "file" the Section 906 certifications. The Section 302 certification will be added as exhibit number 31 in the Regulation S-K and S-B Item 601 exhibit table; the Section 906 certification will be exhibit number 32. Section 906 exhibits will be subject to the signature requirements of Regulation S-T. As a result, companies will be required to retain a manually signed signature page or other authenticating document for a five-year period. In the event that the EDGAR system is not updated by the effective date, companies should submit both the Section 302 and 906 certifications as Exhibit 99.

**Observations** – With respect to Form 11-K annual reports filed by benefit plans, it is clear that Section 302 certifications are not required. However, it is not clear whether the Section 906 certification requirements apply. We understand that the SEC staff has informally indicated that it believes that benefit plans are issuers and that Section 906 certifications are required in Form 11-K filings. The Commission is consulting with the Department of Justice on this and is considering taking additional action.

### Effective Dates and Transition

The SEC delayed the effective dates for the evaluation and reporting on internal controls in view of the effort required for companies and auditors to be in a position to meet these requirements. The Commission had proposed that this be required in annual reports for fiscal years ending on or after September 15, 2003. The final effective dates for the rules requiring companies to evaluate and report on internal control over financial reporting and provide an auditor's attestation report in their annual reports are as follows:

- Companies that meet the definition of an "accelerated filer" (generally U.S. companies that have an equity market capitalization of over \$75 million and have filed an annual report with the SEC) will first be required to do so in their annual reports for fiscal years ending on or after June 15, 2004.
- All other issuers, including foreign private issuers and small business issuers, will be required to do so in annual reports for fiscal years ending on or after April 15, 2005.

**Observations** – In a recent speech given by Scott Taub, Deputy Chief Accountant of the SEC, Mr. Taub urged companies to recognize the effort required and begin immediately, stating, "The need to document the existing internal controls, consider whether other controls should be added, and design

and perform tests of controls indicates that a lot of time is necessary in order for management to be in a position to conclude as to the effectiveness of the company's internal control over financial reporting. Please do not use the extension of the compliance date as a reason to relax, take your eye off the ball, or otherwise not make use of the extra time you've been given. We listened to your concerns about timing, and we believe we've done our part to ensure an effective and smooth implementation of the rules, which is in the best interests of investors. If you don't take advantage of this extra time to work on the implementation, you will not have done your part for investors."

The requirement to evaluate changes in internal control over financial reporting on a quarterly basis is effective for a company's first quarterly report after the first annual report required to include a management report on internal control over financial reporting. This requirement must be distinguished from the requirement to report significant changes in internal control over financial reporting on a quarterly basis if such changes are identified. The requirement to report such changes has been in effect for filings since August 29, 2002, pursuant to Item 307(b) of Regulations S-K and S-B. (Even though no formal evaluation of internal control over financial reporting has been required, registrants might identify such changes through their evaluations of disclosure controls and procedures or other means.) The requirement was changed to require reporting on significant changes during a quarter (rather than after the evaluation date) and was relocated to Item 308(c) of Regulations S-K and S-B. This change in the internal control changes to be reported is effective for periodic reports due on or after August 14, 2003 (even if the report is filed prior to that date).

The following rule changes also apply in periodic reports due on or

after August 14, 2003 (even if the report is filed prior to that date):

- The requirement for management to evaluate and report on disclosure controls and procedures as of the end of the period covered by the report (vs. as of a date within 90 days of the filing date);
- The requirement to change the wording of the Section 302 certifications to conform them to the revised controls evaluation and reporting requirements, with certain exceptions; and
- The requirements to file Section 302 certifications and furnish Section 906 certifications as exhibits.

As indicated above, there are certain exceptions to the requirement to change the wording of the Section 302 certifications to conform them to the revised controls evaluation and reporting requirements. To accommodate the different compliance dates, a company's certifying officers may temporarily modify the content of their Section 302 certifications to omit the references to internal control over financial reporting matters that have a delayed effective date. In that regard, the certifications may temporarily omit the references to (i) responsibility for establishing and maintaining internal control over financial reporting and (ii) having designed the registrant's internal control over financial reporting to provide reasonable assurance regarding reliable financial reporting. These portions of the certifications must be provided when the internal control evaluation and reporting requirements become effective.

**Observations** – While the extended compliance dates give companies time to prepare for reporting on internal control over financial reporting, we agree with Mr. Taub's remarks quoted above indicating that complying will require significant effort and

that companies should begin immediately. In addition to ensuring that a company is in position to comply with the rules, starting immediately may also provide practical benefits. We expect that this effort will enable many companies to identify and implement changes in their internal controls to strengthen them. Also, identifying significant deficiencies and material weaknesses early gives a company time to correct them before the evaluation date and reduces the risk that a company may need to report that its internal controls are not effective.

The steps a company should take to meet the new requirements are discussed below.

### **1. Commit the Necessary Time and Resources**

A company should begin by making the project a high priority and assigning senior level management personnel to lead the effort. A company may find it helpful to establish a committee that will be responsible for executing the process of documenting, testing, and evaluating the company's internal control over financial reporting. If the company has already established a disclosure committee that is responsible for evaluating disclosure controls and procedures, that committee's responsibilities could be extended to include those related to internal control over financial reporting. Like the disclosure committee, the internal control committee should report to senior management, including the certifying officers.

A company must also realistically estimate the time and resources that will be required. In that regard:

- In most cases, the effort required will be significant. In an informal survey conducted by Financial Executives International in May, respondents indicated "that their company employees would be spending an average of 6,700 hours evaluating and enhancing corporate internal controls this year, and that they expected additional spending averaging \$480,000 for such things as evaluation software, outside consulting and employee training." The results are based on 83 responses from public com-

panies with annual sales revenue averaging \$3.27 billion. (These costs do not include amounts to be paid to auditors for their attestation.)

- In addition to having sufficient available time, the people who will perform the work must have the appropriate skills and training.

A company should decide whether it has sufficient internal resources to handle the job or whether external resources will also be needed. Although many qualified service providers are available to participate in these efforts, the demand for their services is currently quite strong.

Whether a company performs the work itself or uses an outside service provider, it should review the approach to be taken and the work to be performed with its auditor to ensure that it will provide an appropriate basis for the auditor to provide an attestation report.

### **2. Select a Suitable Internal Control Framework**

The model recommended by COSO is the one that seems to be most widely recognized. The COSO manual entitled Internal Control – Integrated Framework and related tools can be purchased from the Institute of Internal Auditors (IIA) for \$33 per copy. The IIA can be reached at [www.theiia.org](http://www.theiia.org) or 1-877-867-4957.

### **3. Identify and Document Existing Controls**

In performing this step, a company should build on its existing documentation of internal controls, including its documentation of the disclosure controls that management determines are part of internal control over financial reporting.

### **4. Evaluate Design Effectiveness of Controls**

If the company has not established effective controls to achieve a particular objective, it must design and install effective controls.

### **5. Design and Perform Tests to Evaluate Operating Effectiveness of Controls**

In this step, a company should determine whether the controls it has established are operating as intended. Again, the work

already being performed to evaluate the operating effectiveness of the company's disclosure controls and procedures should be utilized where those controls overlap with the company's internal control over financial reporting.

### **6. Evaluate Controls and Implement Changes**

As a result of the evaluation and testing described above, management should be in a position to assess whether existing controls are adequate to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. Where weaknesses or deficiencies exist, a company should implement changes and subsequently test the changed or additional controls before the date of the first year-end evaluation upon which the company must report externally.

### **7. Monitor Existing Controls and Material Changes**

Management must also establish procedures for monitoring the effectiveness of existing controls, identifying and documenting changes, and evaluating the materiality of the changes on a quarterly basis.

## **Listed Company Audit Committees**

In Release 33-8220, the SEC adopted rules to implement Section 301 of the Act. The rules direct the national securities exchanges and associations to prohibit the listing of the securities of an issuer that is not in compliance with the standards for audit committees as set forth in the Act. The Commission adopted the rules substantially as proposed.

The rules apply to issuers whose securities are listed on a national securities exchange or association (e.g., the NYSE, AMEX, and Nasdaq), all of which are referred to as "exchanges" in this letter. Interdealer quotation systems, such as the OTC Bulletin Board, the Pink Sheets, and the Yellow Sheets, are not affected by the rules.

The rules apply to most types of listed securities, including equity securities, debt securities, and derivative securities.

The rules apply to both domestic and foreign issuers (including small business issuers). The rules also apply to investment companies, although they have been tailored to reflect certain unique aspects of investment companies' organizational structures and safeguards already provided by the Investment Company Act. Several provisions, applicable only to foreign private issuers, have been included to address the special circumstances of particular foreign jurisdictions.

The rules apply to audit committees. Under Section 3(a)(58) of the Exchange Act, as added by Section 205 of the Act, the term "audit committee" is defined as:

- A committee (or equivalent body) established by and among the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and
- If no such committee exists with respect to an issuer, the entire board of directors of the issuer.

The Commission designed its rules to complement expected changes to the exchanges' rules. The exchanges recently reviewed their corporate governance standards, including their audit committee rules, and have proposed changes to their rules to provide more demanding standards for audit committees. In some cases, the proposed exchange rules are more stringent than the SEC's requirements discussed below.

### **Listing Standards**

Under the rules, the issuer's audit committee must meet five standards

for the issuer's securities to be listed:

**1. Independence** – Each member of the audit committee must be independent as defined by the Act. The rules contain two basic criteria for evaluating independence: (1) compensation and (2) affiliate status.

Under the rules related to compensation, a member may not receive, either directly or indirectly, any compensation from the company other than in his or her capacity as a member of the board and its committees.

A member is barred from accepting any direct consulting, advisory, or other compensatory fee from the issuer or an affiliate of the issuer, other than in the member's capacity as a board member. (Compensatory fees do not include the receipt of fixed payments for prior service under a retirement plan of the issuer.)

Indirect compensation includes compensation paid to spouses and children. It also includes payments accepted by an entity in which the member is a partner, member, officer, or holds a similar position if that firm provides accounting, consulting, legal, investment banking, or financial advisory services to the issuer or any subsidiary. The rules do not preclude independence on the basis of other ordinary course of commercial business relationships between the company and an entity with which a director has a relationship. (The exchanges' standards of independence may prohibit such relationships.) The rules also apply only to current relationships with the audit committee member and related persons. (The exchanges' standards of independence may prohibit past relationships.)

A member also must not be an affiliated person of the issuer or any of its subsidiaries. Executive officers, directors who are also employees of

an affiliate, general partners, and managing members of an affiliate are deemed to be affiliates.

The terms "affiliate" and "affiliated person" are consistent with the SEC's definition of those terms under the securities laws. An "affiliated person" is "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified." "Control" is defined as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."

The rules regarding affiliate status provide a safe harbor. A person who is not an executive officer or 10% shareholder of the issuer is deemed not to control the issuer. The ownership level specified in the safe harbor does not create a presumption that a person with a higher level of ownership is an affiliate.

### **2. Responsibilities Relating to Registered Public Accounting Firms**

– The audit committee must be directly responsible for the appointment, compensation, retention, and oversight of the work of the auditor engaged for the purpose of preparing or issuing an audit report or performing other audit, review, or attest services for the issuer, and the registered public accounting firm must report directly to the audit committee. The audit committee must have ultimate authority to retain the outside auditor, which includes the power not to retain (or to terminate) the outside auditor. In addition, the audit committee must have ultimate authority to approve all audit engagement fees and terms.

The SEC had initially proposed to exempt investment companies from the requirement that the audit committee be responsible for the

selection of the independent auditor. As a result of the new auditor independence rules adopted in January, audit committees of investment companies are now required to pre-approve all audit, review, and attest engagements performed by the independent auditor. In order to conform to the new auditor independence requirements, the final rules require the audit committee of an investment company to select the independent auditor. Under Section 32(a) of the Investment Company Act, the independent directors will be required to ratify the selection.

### **3. Procedures for Handling Complaints**

– The audit committee must establish procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting controls, or auditing matters, including procedures for the confidential anonymous submission by employees of concerns regarding questionable accounting or auditing matters. These rules are often referred to as the “whistle-blower” provisions. The rules do not mandate specific procedures that audit committees must establish. The SEC expects that each audit committee will develop procedures that work best consistent with its company’s individual circumstances.

**4. Authority to Engage Advisors** – The audit committee must have the authority to engage independent counsel and other advisors as it determines necessary to carry out its duties.

**5. Funding** – The issuer must provide appropriate funding for the audit committee to compensate the outside auditors and any lawyers and advisors it employs and to fund ordinary administrative expenses of the audit committee that are necessary in carrying out its duties.

### **Exceptions to the Independence Rules**

The rules provide some general exceptions to the independence rules.

- For companies coming to market for the first time, the rules require at least one member of an issuer’s audit committee to be independent at the time of an issuer’s initial listing, a majority of independent members within 90 days, and a fully independent committee within one year.
- The rules permit an audit committee member to sit on the boards of directors of both an issuer and an affiliate of the issuer if the committee member otherwise meets the independence requirements for each entity.
- If a member of an audit committee ceases to be independent for reasons outside the member’s control, the rules permit the member to remain on the audit committee until the earlier of the issuer’s next annual shareholders’ meeting or one year from the occurrence of the event that caused the member’s independence to be impaired.

The rules also provide foreign private issuers with a number of exceptions to the independence rules to accommodate the different legal requirements of some foreign jurisdictions:

- A foreign private issuer’s audit committee may include an employee as a member, as long as he or she (i) is not an executive officer of the company and (ii) is elected or named to the board of directors or audit committee pursuant to the issuer’s governing law or documents, an employee collective bargaining agreement, or other home country legal or listing requirements.

- A foreign private issuer’s audit committee may include a member who is an affiliate of the company or a representative of an affiliate if (i) the member has only observer status on the committee (i.e., the member has no voting power) and (ii) neither the member nor the affiliate is an executive officer of the company.
- A foreign private issuer’s audit committee may include a member that is a representative of a foreign government that is an affiliate of the foreign private issuer if the member is not an executive officer of the company.
- The independence rules also accommodate foreign private issuers that operate under a dual holding company structure. The rules permit a listed issuer to designate one audit committee for both companies so long as each member of the audit committee is a member of the board of directors of at least one of the holding companies.
- In addition to the exceptions noted above, the rules allow the Commission to exempt an audit committee member from the independence requirements as it determines appropriate in light of the circumstances.

### **General Exemptions**

A number of general exemptions from the rules were also provided:

- If an issuer has a class of securities that is listed on an exchange and subject to its listing requirements, the listing of additional classes of securities on the same exchange or another exchange is exempt from the rules.
- The listing of classes of non-equity securities of a direct or indirect consolidated subsidiary of a listed issuer or an at least 50% beneficially owned subsidiary is exempt from the rules.

- Subject to certain conditions, the listing of securities of a foreign private issuer is exempt from the rules if the foreign private issuer has a board of auditors (or similar body) or has statutory auditors that are generally required, to the extent permitted by law, to meet the standards contained in the rules.
- The listing of a securities futures product or a standardized option is not subject to the rules.
- Asset-backed issuers, unit investment trusts, foreign governments, and issuers organized as passive trusts or other unincorporated associations that do not have a board of directors are exempt from the rules.

The instructions to the rules address potential conflicts between the rules and the home country laws of foreign private issuers. They clarify that the rules do not conflict with nor affect the application of any requirement or ability under a listed issuer's governing law or documents or home country legal or listing provisions that requires or permits shareholders to vote on, approve, or ratify any of the audit committee requirements. To the extent permitted by the issuer's home country law, the audit committee should be responsible for making recommendations or nominations regarding such matters.

### **Disclosure Requirements**

The new rules also require certain disclosures. New Item 401(i) of Regulation S-K (as well as the companion rules adopted for small business issuers) requires an issuer to include in its annual report the names of each audit committee member. If an issuer does not have a separate audit committee, it must state that the entire board of direc-

tors is acting as the audit committee. This information was previously required only in proxy or information statements where action is to be taken with respect to the election of directors.

In addition, an issuer that relies on (1) certain of the exceptions to the independence standards described above, including those provided for foreign private issuers, or (2) the general exemption from the audit committee requirements provided for a foreign private issuer that has a board of auditors or statutory auditors must disclose this fact in its annual report and its proxy or information statement for shareholders' meetings at which directors are elected. The disclosure must include the issuer's assessment of whether, and if so, how, such reliance would materially adversely affect the ability of the audit committee to act independently and to satisfy the other requirements of the rules.

The annual report disclosures described above may be provided by incorporating by reference to an issuer's proxy statement.

### **Enforcement**

The rules do not establish specific mechanisms for exchanges to ensure that issuers comply with the standards on an ongoing basis. They direct the exchanges to require a listed issuer to notify the applicable exchange promptly after an executive officer of the issuer becomes aware of any material noncompliance with the requirements.

The rules require the exchanges to provide appropriate procedures for an issuer to have an opportunity to cure any defects that would be the basis for delisting the issuer's securities as a result of its failure to meet the rules before imposition of a delisting.

### **Updates of Other Rules**

The rules update the existing disclosure requirements in proxy and information statements regarding the independence of audit committee members to reflect the new rules to be adopted by the exchanges. The rules clarify that if the registrant does not have a separate audit committee, the disclosure must be provided for all members of its board of directors.

The rules also update the Commission's rules requiring audit committee financial expert disclosures, which were adopted in January. As a result, an issuer will evaluate the independence of its audit committee financial experts using the enhanced independence standards that will be reflected in the rules to be adopted by the exchange on which its securities are listed. If an issuer is not listed, it will make the evaluation using the standards of an exchange of its choice. In addition, a foreign private issuer will be required to evaluate and disclose whether its audit committee financial expert is independent. It will do so using the same approach and standards as a domestic issuer.

### **Effective Dates**

The exchanges must adopt revised listing standards as follows:

- They must submit proposed rules or rule amendments that comply with the requirements no later than July 15, 2003.
- Final rules or amendments must be approved by the SEC no later than December 31, 2003.

Issuers must comply as follows:

- Issuers other than foreign private issuers and small business issuers must be in compliance with the new listing rules by the earlier of (i) their first annual shareholders' meeting after January 15, 2004, or (ii) October 31, 2004.

- Foreign private issuers and small business issuers must be in compliance with the new listing rules by July 31, 2005.

## Improper Influence on Conduct of Audits

Section 303 of the Act makes it unlawful for officers and directors of an issuer, and persons under their direction, to improperly influence the auditor of the issuer's financial statements. To implement Section 303, the SEC adopted new Exchange Act Rules 13b2-2(b) and (c). The rules prohibit an officer or director of an issuer, or any other person acting under the direction thereof, from directly or indirectly taking any action to coerce, manipulate, mislead, or fraudulently influence any independent public or certified public accountant engaged in the performance of an audit or review of the financial statements of that issuer if that person knew or should have known that such action, if successful, could result in rendering such financial statements materially misleading. Much of the misconduct addressed by the new rules generally would be subject to other provisions of the securities laws and the Commission's regulations. The new rules are outlined in Release 34-47890.

The rules apply to officers and directors and any "person acting under the direction thereof." The term "officer" includes the company "president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer, and any person routinely performing corresponding functions." The term also includes the company's chief executive officer and other executive officers. "Any other person acting under the direction thereof" encompasses a broader category of people than

those under the supervision or control of an officer or director. Such persons might include:

- Employees, customers, vendors, or creditors who, under the direction of the officer or director, provide false or misleading confirmations or other false or misleading information to auditors, or who enter into "side agreements that enable an issuer to mislead its auditor" and
- Partners or employees of an accounting firm, such as consultants or forensic accounting specialists retained by counsel for the issuer, and attorneys, securities professionals, or other advisors who, for example, pressure an auditor to limit the scope of the audit, to issue an unqualified report on the financial statements when such report would be unwarranted, to not object to an inappropriate accounting treatment, or not to withdraw a report on the company's financial statements.

The rules apply when an auditor is "engaged in the performance of an audit." This includes the professional engagement period and any other time the auditor is called upon to make decisions or judgments regarding the issuer's financial statements. This includes the period when negotiations for retention of the auditor take place. It also includes the period subsequent to the professional engagement period when the auditor is considering whether to issue a consent to the use of a prior year's audit report.

Under new Rule 13b2-2(b)(2), actions that improperly influence an auditor include, but are not limited to, actions taken to coerce, manipulate, mislead, or fraudulently influence an auditor to:

- Issue or reissue a report on an issuer's financial statements that is not warranted in the circumstances due to violation of gen-

erally accepted accounting principles, generally accepted auditing standards, or other professional standards;

- Not perform an audit, review, or other procedures required by generally accepted auditing standards or other professional standards;
- Not withdraw an issued report; or
- Not communicate matters to an issuer's audit committee.

In the discussion in the release, the Commission lists types of conduct that it believes might constitute improper influence. They include, but are not limited to, directly or indirectly:

- Offering or paying bribes or other financial incentives, including offering future employment or contracts for non-audit services;
- Providing an auditor with inaccurate or misleading legal analysis;
- Threatening to cancel or canceling existing non-audit or audit engagements if the auditor objects to the issuer's accounting;
- Seeking to have a partner removed from the audit engagement because the partner objects to the issuer's accounting;
- Blackmailing; and
- Making physical threats.

The discussion in the release also states that the Commission does not intend to hold any party accountable for honest and reasonable mistakes or to sanction those who actively debate accounting or auditing issues.

The rules took effect June 27, 2003.

**Observations** – *If an issuer identifies violations or potential violations of these rules, it should also consider the implications under other provisions of the securities laws and other Commission regulations. In that regard, under other recently adopted Commission rules:*

- *An attorney appearing and practicing before the Commission is required to*

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report material violations of laws “up the ladder” within an issuer.

- Companies that have adopted a code of ethics will need to consider what actions they must take if the conduct violates that code.

In addition, auditors will need to consider their responsibilities under Section 10A of the Exchange Act, which requires them to report likely illegal acts to management and assure that the issuer’s audit committee is informed of the act.

## For Further Information

If you would like further information or to discuss the implications of these rules, please contact the BDO Seidman, LLP engagement partner serving you or one of the following partners:

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## The SEC’s Releases

Below are links to the SEC’s proposing and adopting releases covering the new rules discussed in this letter.

### Internal Control Reporting:

Final Rule – Release 33-8238, *Management’s Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*  
(<http://www.sec.gov/rules/final/33-8238.htm>)

Proposed Rule – Release 33-8138, *Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002*  
(<http://www.sec.gov/rules/proposed/33-8138.htm>)

### Listed Company Audit Committees:

Final Rule – Release 33-8220, *Standards Relating to Listed Company Audit Committees*  
(<http://www.sec.gov/rules/final/33-8220.htm>)

Proposed Rule – Release 33-8173, *Standards Relating to Listed Company Audit Committees*  
(<http://www.sec.gov/rules/proposed/34-47137.htm>)

### Improper Influence on Conduct of Audits:

Final Rule – Release 34-47890, *Improper Influence on Conduct of Audits*  
(<http://www.sec.gov/rules/final/34-47890.htm>)

Proposed Rule – Release 34-46685, *Improper Influence on Conduct of Audits*  
(<http://www.sec.gov/rules/proposed/34-46685.htm>)

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**Material discussed in this *Financial Reporting* newsletter is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual facts and circumstances.**

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