

Internal Controls -- Disclosure and Attestation Requirements

At an open meeting yesterday, the SEC adopted a final rule to implement Section 404 of the Sarbanes-Oxley Act of 2002. Section 404 requires the SEC to adopt rules requiring public companies to include, in their annual reports, a statement by management regarding the effectiveness of their companies' internal controls for financial reporting. Under Section 404, each company's auditor also must attest to management's evaluation of the internal controls. The SEC issued a proposed rule on this subject in October 2002. Release No. 34-46685 (Oct. 18, 2003) <http://www.sec.gov/rules/proposed/34-46685.htm>. The SEC's press release regarding the open meeting is available at <http://www.sec.gov/news/press/2003-66.htm>.

The text of the final rule, and the accompanying adopting release, are not yet available. However, at yesterday's open meeting, the staff of the SEC noted several significant aspects of the final rule:

- The new rule defines "internal controls" based on the definition of such term contained in the report of the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). The proposed rule, in contrast, had used the definition of internal controls contained in the AICPA's Codification of Statements on Auditing Standards Section 319. According to the staff, this change was made in response to comments on the proposed rule.
- Under the final rule, the conclusions in management's annual report regarding the effectiveness of its internal controls must be measured against an identified framework of internal controls. The rule is expected to endorse the COSO framework of internal controls but will leave open the possibility that other frameworks could be used, so long as they are widely recognized and are produced through a public, deliberative process.
- No quarterly reports on internal controls will be required. Nonetheless, companies will still be required to include in their quarterly reports certain disclosures regarding significant changes in their internal controls, and CEO's and CFO's will continue to be required to make quarterly certifications with respect to such matters.
- "Accelerated filers" must comply with the new rule beginning with the first fiscal year ending after June 15, 2004. All others, including small business issuers and foreign issuers, must comply beginning with fiscal years ending after April 15, 2005. These transition dates are more generous than had been anticipated by many observers, in part to allow the Public Company Accounting Oversight Board ("PCAOB") to issue standards governing the required attest report. The staff confirmed its view that the PCAOB is now the sole authority with respect to setting auditing and attest standards for firms auditing public companies.
- Financial institutions already subject to internal control reports under banking regulations can submit a single report that meets the requirements of both those regulations and the new rule.
- The SEC's staff confirmed its view that the preparation and delivery of an attest report by the company's regular accounting firm, as required by the new rule, would not hinder the independence of such firm.

- At the open meeting, the SEC also adopted proposed technical changes to the Section 302 and Section 906 officer certifications (including making such certifications exhibits to reports). These will become effective 60 days after publication of the rule change in the Federal Register.

*David B.H. Martin
David H. Engvall*

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

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

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