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Developing Procedures to Comply with the New SEC Certification Requirements

In connection with the implementation of Section 302 of the Sarbanes-Oxley Act of 2002 (the "Act"), the SEC has adopted new rules containing certification requirements for periodic reports filed with the SEC. These requirements apply to all reporting companies, both U.S. and non-U.S. In addition, the SEC has proposed, but not yet adopted, further certification requirements to implement Section 404 of the Act.

The newly adopted rules require each reporting company to establish and maintain "disclosure controls and procedures," which is defined in the new rules as controls and other procedures of a reporting 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.

Disclosure controls and procedures are distinct from "internal controls and procedures for financial reporting," a related but separate concept already existing in the accounting literature and the securities laws and rules. Even before adoption of the Act and related rules, reporting companies were (and remain) required pursuant to Section 13(b)(2) of the Exchange Act to establish and maintain systems of internal controls with respect to their financial reporting. The new rules are intended to ensure that a company *also* maintains commensurate procedures for gathering, analyzing and disclosing all financial and non-financial information that is required to be included in its periodic and current reports (whether or not such reports are covered by certification requirements).

Under the new rules, a company's principal executive officer (generally the CEO) and principal financial officer (generally the CFO) must certify, among other things, that:

- they are responsible for establishing and maintaining disclosure controls and procedures for the company;
- they 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;
- they have evaluated the effectiveness of the company's disclosure controls and procedures; and
- they have presented in the report their conclusions about the effectiveness of the disclosure controls and procedures based on the required evaluation.

The proposed rules to implement Section 404 of the Act, if adopted, would require additional, but similar, quarterly certifications with respect to internal controls and procedures for financial reporting. The proposed rules would also call for an annual internal control evaluation and report which would be subject to an attestation and report by the company's auditors in connection with their audit.

A summary of the recently adopted certification requirements is included in our September 5, 2002 memo entitled, "SEC Issues Rules for CEO/CFO Certifications of Quarterly and Annual Reports and Internal Disclosure Controls and Procedures." A summary of the proposed additional certification requirements regarding internal controls and procedures for financial reporting is contained in our October 25, 2002 memorandum entitled, "SEC Proposes Rules Regarding Internal Controls and Procedures for Financial Reporting."

This memorandum sets out considerations for developing disclosure controls and procedures and a review process that will comply with the requirements of the new rules and permit CEOs and CFOs to make the necessary certifications. Although legal and accounting standards establishing internal controls and procedures for financial reporting already exist, reporting companies and their auditors will likely re-examine their internal controls in connection with the proposed new rules. In addition, internal controls and procedures for financial reporting may also be the subject of further interpretation and guidance by the Public Company Accounting Oversight Board. Because the proposed rules call for quarterly evaluations of, and certifications regarding, internal controls, we discuss them in the context of the quarterly evaluations of, and certifications regarding, disclosure controls and procedures.

I. Disclosure Controls and Procedures

The procedures discussed in this memorandum can serve various purposes. Although they may seem to many companies to be a formalization of current best practices, disclosure controls and procedures are now mandated by the SEC, and failure to maintain them could result in enforcement action, even though a company's disclosure may be accurate and complete. In addition, these procedures will be useful in enabling CEOs and CFOs to make the certifications called for by Sections 302 and 906 of the Act.

Neither the Act nor the SEC rules adopted or proposed under the Act specify any particular procedures that companies must adopt. Instead, each company needs to develop procedures that are consistent with its business and internal management and supervisory practices.

A. Objective

The SEC made it clear that the objective of disclosure controls and procedures is to ensure that public companies' internal communications and other procedures operate so that information required to be disclosed in SEC reports flows to the appropriate collection, evaluation and disclosure points in a timely manner. This is especially needed in light of the recently adopted rules reducing the time for filing Forms 10-K and 10-Q and the proposals to expand the items that are reportable on Form 8-K and to accelerate the deadlines for 8-K filings. The procedures can also be helpful in identifying and disseminating material information in order to comply with the requirements of Regulation FD.

Specifically, disclosure controls and procedures should be designed to:

- ensure timely collection and evaluation of information potentially subject to disclosure under the requirements of Regulation S-K (non-financial information), Regulation S-X (financial information) and the related SEC disclosure forms;

- capture information that is relevant to an assessment of the need to disclose developments and risks that pertain to the company's businesses; and

- cover information that must be evaluated in the context of the disclosure requirement of Exchange Act Rule 12b-20, which provides that "in addition to the information expressly required to be included in a statement or report, there shall be added such further material information, if any, as may be necessary to make the required statements, in the light of the circumstances under which they were made, not misleading."

B. The Disclosure Committee

The one concrete procedural element that the SEC did recommend is that companies create a Disclosure Committee with responsibility for considering the materiality of information and determining disclosure obligations on a timely basis and that such a committee report to senior management, including the principal executive officer and the principal financial officer. We think the Disclosure Committee can also serve as the central coordinating group for the company's public disclosure.

Selection. The CEO and the CFO should select the members of the Disclosure Committee.

Membership. Officers and employees of the company that have an interest in, and the expertise to serve on, the committee include:

- the principal accounting officer or the controller;

- the general counsel or other senior legal official with responsibility for disclosure matters who reports to the general counsel;

- the principal risk management officer;

- the chief investor relations officer (or an officer with equivalent responsibilities); and

- such other officers or employees, such as heads of business segments, heads of key business units, a business development representative and a human resources representative, as the company deems appropriate.

While membership will of course vary from company to company, the list outlined above suggests a level of seniority and company-wide responsibility appropriate for understanding the total disclosure record of the company and evaluating the materiality of new information as it becomes available.

Responsibility. The Disclosure Committee should have overall coordinating responsibility for the company's public disclosure, including:

- all periodic reports;
- all current reports on Form 8-K;
- all registration statements (and private placement memoranda);
- all press releases containing financial information or providing earnings guidance;
- all presentations to analysts, investor conferences and rating agencies and all road show presentations for offerings;
- all other correspondence sent to shareholders; and
- the investor relations portion of the company's web site.

C. The Role of the CEO and CFO

Although the company's most senior officers may not necessarily be members of the Disclosure Committee or actively involved in the preparation of reports, it is important for them to establish the appropriate "tone at the top." They must send a clear message to the entire organization that the company places a high priority on the best disclosure practices and that it is the responsibility of all employees to protect the integrity of the company's systems and procedures.

Execution of employee responsibilities in the disclosure process should be a part of the overall employee evaluation and the failure to discharge duties should be grounds for discipline. Those responsible for gathering information must have a clear mandate and authority from the top of the organization to perform their duties. Senior management should maintain an "open door" policy for any individual who wants to raise issues or ask questions about the company's reporting obligations and disclosure. Because the certification required of the CEO and CFO are personal certifications, the CEO and CFO must remain actively involved in the disclosure process.

In addition, the CEO and the CFO must be in a position to state that they have designed the disclosure controls and procedures to ensure that the information gathered as a result of the procedures is made known to them.

Finally, the CEO and CFO will have to participate in the evaluation process and be in a position to report on their evaluation, as discussed in Part III below.

D. Organizing the Disclosure Process

The role of the Disclosure Committee will vary from company to company. In some cases, the members of the Disclosure Committee could also take a leading role in coordinating the gathering, evaluation and review of information. In other cases, this responsibility will be delegated to a subset of the members of the Disclosure Committee or to a separate department or group that reports to the Disclosure Committee. In any case, it is important that the disclosure coordinating function be adequately staffed and it is critical that those performing it have adequate authority within the company.

Set forth in Sections E through H below is a framework for a disclosure procedures model in which the Disclosure Committee is the central organizing body for the gathering and analysis of information, the preparation of disclosure documents and the coordination of the review of those documents for accuracy and completeness.

At the outset, the CEO and the CFO should meet with the Disclosure Committee and outline their view of the committee's role and responsibilities. Procedures should be established and a written record of proceedings should be kept. The formalities of the committee (e.g., a charter and regular meetings) may very depending on the size of the company.

E. Information Gathering

Identify Required Information. The Disclosure Committee's first responsibility should be to ensure that all information relevant to the company's disclosure obligations is reported to the persons responsible for the evaluation and dissemination of the information. The first step in this task is for the persons responsible for coordinating the preparation of the company's disclosure to familiarize themselves with the company's disclosure obligations. This should include an understanding of:

- the information called for by the various Exchange Act reporting forms, Regulation S-K (including information required for the MD&A) and Regulation S-X; and

- information relevant to an assessment of risk disclosure, including industry information and regulatory developments.

To gain a basic orientation on these issues, counsel and the company's auditors can and should be consulted. We believe that in setting about the information gathering process, companies should follow the model of the due diligence process used in connection with a registered securities offering.

Identify Sources of Information. Having identified the information that must be gathered, the Disclosure Committee should then identify the sources of that information, either by individual or by department (or in some cases external sources). Those individuals or departments should be instructed to provide the identified types of information. To the extent that a reporting person is charged with providing information responsive to a particular disclosure requirement, that person should be made aware of the requirements for the disclosure. However, materiality decisions should be left for the most part to the Disclosure Committee, which are in a better position to evaluate materiality from the point of view of the company as a whole. Individual members of the Disclosure Committee should oversee gathering from areas within their particular expertise. For example,

- legal personnel should oversee the gathering of information regarding management and the board of directors, subsidiaries, material contracts and litigation;

- accounting personnel should oversee the collection of information regarding executive compensation and customer concentration; and

- investor relations personnel should take responsibility for keeping the Disclosure Committee appraised of the company's current disclosure record (including press releases and management presentations) as well as information from sources outside the company such as comparable public companies, securities analysts, trade associations and rating agency reports about the company and its industry.

Personnel involved the preparation of the company's reports should be made aware of a person or persons that they can contact (including on an anonymous basis) if they have need of legal or other advice in the course of their work. No one should be made to feel that they have no place to turn to if an issue should arise or if there is something that they wish to raise without going through their supervisor.

Report Information to the CEO and CFO. The CEO and CFO must be in a position to state that the information gathered for disclosure is made known to them and on a timely basis.

Ensure procedures are on-going. Especially in light of the adoption of new rules for accelerated filing requirements for most reportable information and further proposals likely to follow the Act's mandate of "real time" disclosure, it is critical that the company treat information gathering as a continuous process. In identifying the sources of information and establishing reporting lines, it will be critical to ensure that the information flow is continuous, not just at the end of each quarter. The Disclosure Committee should have procedures in place to be notified of events requiring disclosure between periodic reports (e.g., changes to earnings guidance, events requiring 8-K disclosure).

F. Preparing Disclosure Reports

The Disclosure Committee should take the lead role in organizing the drafting of the company's disclosure documents, using the information that it has gathered. Those preparing the draft reports should take advantage of opportunities to compare information from various sources. For example,

- information gathered from management's projection and budgeting processes (not to mention publicly disclosed "guidance") should be compared to actual results to identify trends and other changes that are affecting the company's results;

- information regarding transactions with management and other affiliates should be gathered from both legal and accounting sources and should be cross-checked; and

- information gathered through legal personnel regarding management compensation contracts should be checked against payroll data gathered by the accounting or human resources staff.

G. Internal Review Process

SEC reports should be drafted sufficiently in advance of their filing deadlines to permit time for thoughtful review prior to filing. The SEC has expressed a concern not only that the information contained in a report be accurate, but that it also be complete. Drafts of annual and quarterly reports should be circulated back "down" through the reporting channels from which the information used to draft the reports came, as well as "up" to senior management for their review. Reviewers should be admonished to review the entire report, not just the portions that they prepared, to ensure that information in the report is thoroughly vetted and cross-checked and to assure that important information is not omitted.

As called for by existing rules and governance standards, the company's outside auditors and the company's audit committee must review the company's quarterly and annual reports. The company's disclosure counsel should also review the report within a time frame sufficient to permit thoughtful comments and any follow-up work that may be necessary.

At the outset of each fiscal year, a timetable and allocation of responsibilities should be established and communicated to all participants in the disclosure process. As part of the process the Disclosure Committee should review prior practice and determine whether changes need to be implemented to respond to negative evaluations of the process or to otherwise improve the process.

By way of example, a draft report could be circulated to:

- Preliminary Drafts
    - Other members of drafting group
    - Providers of raw information to confirm data and cross-check consistency

- First Draft
    - Group or business unit accounting heads
    - Controller/Chief Accounting Officer staff

- Second Draft
    - Group or business unit management
    - Company-wide management

- Disclosure Committee
- Auditors
- Disclosure counsel

- Third Draft

    - Audit Committee
    - CEO and CFO
    - Board of directors

Of course, whenever drafts of disclosure documents are circulated, it is important that they be subject to appropriate confidentiality procedures and the company's document retention policies.

II. Internal Controls and Procedures for Financial Reporting

In adopting rule to implement Section 302 of the Act, the SEC 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. In proposing additional rules to implement Section 404 of the Act, the SEC has proposed defining "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 Public Company Accounting Oversight Board.

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' 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.

III. Evaluation of Procedures

New Exchange Act Rules 13a-15 and 15d-15 require that the company, under the supervision and with the participation of management, including the CEO and CFO, conduct an evaluation of the effectiveness of the design and operation of the company's disclosure controls and procedures within 90 days prior to the filing date of any quarterly or annual report filed under the Exchange Act or, in the case of 20-F/40-F filers, within 90 days of the filing of such report (this requirement is proposed to be amended to require an evaluation as of the relevant period end). In addition, the CEO and CFO are required to certify in the report that:

- they have conducted the required evaluation; and

- they 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.

The CEO and CFO are also required to certify that:

- they have disclosed to the company's auditors and to the audit committee of the board of directors (or persons fulfilling the equivalent function):

  - all significant deficiencies in the design or operation of internal controls which could adversely affect the company's ability to record, process, summarize and report financial data and have identified for the company'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 company's internal controls; and

- they 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.

New items in the annual and quarterly report forms and new Item 307 of Regulation S-K require inclusion in those reports of the information called for in the certifications.

In addition, the rules proposed to implement Section 404 of the Act would require that each annual report filed under Section 13(a) or 15(d) of the Exchange Act contain an internal control report, which would include:

- a statement of the management's responsibility 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, as of the end of the most recent fiscal year; and

- an attestation and report by the company's auditors as to management's evaluation of the company's internal controls and procedures for financial reporting.

The proposed rules would also require that the company conduct a quarterly evaluation of the effectiveness of the design and operation of the company's internal controls and procedures for financial reporting in addition to the quarterly evaluation regarding disclosure controls and procedures. The proposed rules also call for comparable certifications.

With regard to the conduct of the evaluation, no particular evaluation procedures are mandated. The evaluation must, at a minimum, address the matters specified by the rules and certifications. The SEC indicated that it expects that the evaluation would be carried out in a manner that would form the basis for the required certifications regarding the evaluation of controls. In the case of the internal control evaluation, some guidance may be provided by the examination necessary for the company's auditor's to provide their attestation and opinion regarding the annual evaluation.

In order for the CEO and CFO to make the required certifications, the evaluation should identify, at a minimum, any material weakness in the company's disclosure controls and procedures, any other deficiency that would significantly adversely affect the company's ability to collect, process or disclose required information on a timely basis and any material changes in these procedures, including any corrective actions, that the company has taken or is taking with regard to the identified weaknesses or deficiencies.

The new rules do not specify who should conduct the evaluation, just that the evaluation be supervised by management and with management's participation, including the CEO and CFO. One possibility is for the Disclosure Committee to undertake or direct the evaluation. However, it would be prudent for the persons conducting the evaluation to not be the same persons who lead the disclosure process, thus providing a degree of independence. The company's board of directors should review the results of the evaluations, at least annually, because the process can benefit from the different perspectives and experience of the directors and because this participation should aid individual directors in fulfilling their fiduciary responsibilities to the company.

In conducting its review of the effectiveness of its disclosure controls and procedures, the company should review the performance of the disclosure process in terms of identified weaknesses and mistakes as well as evaluating ways that the company's systems can grow and evolve with its business so that weaknesses do not arise in the future. Areas of inquiry should include a review of:

- inaccuracies or omissions identified during the review phase of the reporting process to determine the source and cause. Any pattern in the errors should be identified and addressed. An additional general review of the company's past disclosure with the benefit of "20-20 hindsight" should also be used to identify areas of concern.

- any comments received from the SEC staff on the company's filings. Questions asked by investors and analysts (especially recurring questions or patterns) should also be identified and addressed.

- the sources used in the gathering process, including an evaluation of the people involved, to ensure that they continue to be the best source for information as personnel and responsibilities change and to ensure that they devote adequate time and attention to the disclosure process.

- the adequacy of the time allowed for each step of the process, including the necessary reviews.

A review of the company's internal controls with respect to financial reporting will, if the proposed rules are adopted, be subject to an annual attestation and report by the company's auditors which will become part of the regular audit process. The company's auditors already provide a report regarding any material weaknesses they find in a company's controls as part of the existing audit process. Any weaknesses observed by the independent auditors should be carefully examined in the context of the overall review process. It can be expected that these annual procedures will provide a model for establishing procedures for the proposed quarterly evaluations.

Those conducting the evaluation should request the assistance of the company's audit committee and internal audit group, as well as the company's external auditors and legal counsel, in conducting the evaluation, at a minimum, to compare their thoughts on the process and to provide additional resources for further inquiry where necessary.

IV. CEO/CFO Review and Certification

The company's chief executive officer and chief financial officer are required to make the certifications called for by Sections 302 and 906 of the Act and will be required to make the certifications called for by Section 404 of the Act when the implementing rules are adopted. They should therefore be given ample opportunity to read the report and discuss it with the Disclosure Committee, other members of management and the audit committee. While the amount of "due diligence" that the CEO and CFO will require prior to making the certification will depend on their degree of familiarity with the details of the company's financial results, its public filings and its approach to accounting issues, the following steps should be considered:

- Carefully review the company's financial results and how they were prepared. Speak to the company's senior accounting officers, with particular attention given to any material discretionary issues and accounting policies under generally accepted accounting principles ("GAAP").

- Carefully review the non-financial statement information in the remainder of the report, especially the Management's Discussion and Analysis of Financial Condition and Results of Operations (the "MD&A"). Discuss the report with the principal authors of the MD&A and the descriptions of the company's businesses. Focus on the information included in the report and review any matters excluded from the report, with attention to any material discretionary judgments. Focus not only on historical results, but on possible trends and the adequacy of forward-looking disclosure concerning such trends. Also address the critical accounting estimates and the underlying assumptions.

- In reviewing financial disclosure, remember that compliance with GAAP may not be sufficient. In certifying that the financial disclosure "fairly presents" financial condition, results of operations and cash flows, the CEO and CFO will also be certifying as to:

  - selection of appropriate accounting policies;
  - proper application of appropriate accounting policies;
  - disclosure of financial information that is informative and reasonably reflects the underlying transactions and events; and
  - the inclusion of any additional disclosures necessary to provide investors with a materially accurate and complete picture of financial condition, results of operations and cash flows.

- Discuss the report with the company's in-house or external disclosure counsel. Ask counsel to confirm that the report meets the form requirements of the Securities Exchange Act referred to in the certification.

- Review with the appropriate officers responsible for internal controls the procedures that were followed in preparing the report. Review a list of the persons from whom information was gathered and to whom the draft report was circulated. Consider whether information was gathered from the persons best able to provide it and whether the report was circulated to the persons best able to assure its accuracy and completeness. Assess the adequacy of the time and resources devoted to the preparation of the report.

- Review the company's internal controls and procedures for financial reporting with officers responsible for maintaining such controls, including any changes to the nature and scope of procedures relating to internal controls. Review issues raised by the company's auditors regarding the company's internal controls and procedures for financial reporting. Consider how such issues, or any other issues raised concerning weaknesses in the financial and reporting systems or internal controls, have been addressed. Inquire about any impact that company growth, internal reorganization or changes in accounting standards may be having on the effectiveness of the company's controls.

- Identify issues that are worth further consideration. Consider issues raised in past SEC comment letters, issues identified by the company's auditors, issues raised internally involving the disclosure and financial reporting process, judgments or discretion and issues raised by analysts or others outside the company. Think about where mistakes would be most likely to occur and where others in the company's industry have had problems.

- Meet with the company's outside auditors so that the auditors can share any additional views or thoughts that they may have. Ask them about adjustments to the company's financial statements that they have recommended. Ask if there are any alternative treatments that the company should be considering in preparing its financial statements. Review with them the SEC's "hot-button" accounting issues (*e.g.*, earnings management, off-balance sheet transactions, related party transactions) and disclosure issues (*e.g.*, pro forma figures) and any other accounting or disclosure issues receiving attention in the company's industry.

- Meet with the audit committee, and with the full board if necessary, to understand any questions or concerns that they may have identified concerning the company's disclosure and financial reporting systems, internal controls, risk assessment and risk management policies, auditor independence and effectiveness, financial statements and other public disclosure, or any related matters.

- Review the representation letters delivered by officers of the company to the outside auditors.

- Consider the advantages and disadvantages of obtaining back-up certification from the principal internal officers who participated in the preparation of the report. At a minimum ask the personnel involved in the preparation of the report if they are comfortable with its contents (would they sign the certification if they were you?). Ask them what have they done to ensure the accuracy of the report.

Minutes should be kept of CEO and CFO review. Schedules or checklists indicating the process used to prepare the report, a list of the participants involved in the preparation of the report and a list of the persons to whom drafts of the report were circulated should be reviewed with the CEO and CFO and retained.

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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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