

**GUIDELINES FOR ESTABLISHING AND EVALUATING
DISCLOSURE CONTROLS AND PROCEDURES**

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Guidelines for Establishing and Evaluating Disclosure Controls and Procedures

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Public companies are now required to establish and evaluate disclosure controls and procedures under new rules that the Securities and Exchange Commission (SEC) adopted on August 29, 2002.¹ Rules 13a-15 and 15d-15 under the Securities Exchange Act of 1934, (Exchange Act), require public companies to maintain and evaluate the effectiveness of the design and operation of their disclosure controls and procedures. New Rules 13a-14(c) and 15d-14(c), define disclosure controls and procedures as follows:

controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer in the reports that it files or submits under the [Exchange] Act . . . is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the [Exchange] Act is accumulated and communicated to the issuer's management, including its principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosures.

The importance of disclosure controls and procedures is underscored by the requirements in Rules 13a-14 and 15d-14 under the Exchange Act that principal executive and principal financial officers of public companies, or persons performing similar functions (Principal Officers) sign certifications that must be included in quarterly and annual reports required under the Exchange Act.² These certifications include statements regarding the Principal Officers' responsibilities for establishing, maintaining, and evaluating the disclosure controls and procedures and the disclosure in the applicable report of the Principal Officers' conclusions as to the effectiveness of the disclosure controls and procedures as of a date within 90 days prior to the filing date of the report.³

The certifications also include various statements relating to the company's internal controls, but the term internal controls is not defined in any existing SEC rule.⁴ The Adoption Release pointed out, however, that disclosure controls and procedures must ensure that information required by Regulation S-X, among other rules, is properly included in reports filed under the Exchange Act, thereby suggesting that the term disclosure controls and procedures encompasses at least some of the internal controls that companies maintain in accordance with Section 13(b) of the Exchange Act.⁵ On November 8, 2002, the SEC's Division of Corporation Finance issued guidance that confirms this suggestion. There, the Division stated that "[s]ome elements of internal controls are included in the definition of disclosure controls and procedures."⁶

This White Paper is provided as a general informational service to clients and friends of Morgan, Lewis & Bockius LLP. It should not be construed as imparting legal advice on any specific matter.

The guidelines suggested in this article do not include guidelines for the establishment of internal controls. Section 13(b)(2)(B) has required companies to have internal controls since its enactment in 1977. Therefore, most companies probably have already documented at least a portion of their internal controls relating to the preparation of financial statements. This article defines such internal controls relating to the preparation of financial statements as “financial internal controls” although the SEC’s recent release proposing rules to implement Section 404 of the Sarbanes-Oxley Act of 2002 (SOA), requiring annual management reports on internal controls (404 Proposal Release) uses the term “internal controls and procedures for financial reporting.”⁷ These guidelines contemplate that most financial internal controls are a part of the disclosure controls and procedures so that, together, they will achieve the goals of timely, accurate, and reliable disclosure of financial and nonfinancial information.

Given the requirements for annual reports of management on financial internal controls and the attestation of financial internal controls in Section 404 of SOA,⁸ companies should carefully review the adequacy of their financial internal controls as soon as possible. This review would benefit from consideration of the framework for evaluating financial internal controls described by the Committee of Sponsoring Organizations (COSO) of the Treadway Commission in its report entitled *Internal Control – Integrated Framework* (1994) (COSO Report). This Report describes five interrelated components of financial internal controls: (1) control environment, (2) risk assessment, (3) control activities, (4) information, and (5) communication monitoring. In addition, the Report sets forth criteria and tools that may be useful to an evaluation of financial internal controls.

In considering the guidelines set forth below, companies should recognize that the SEC did not mandate any particular disclosure controls and procedures, and that there is no “one-size-fits-all” approach. The manner in which companies record, gather, process, summarize, and report information undoubtedly will differ depending upon a company’s line of business, size, management philosophy, structure, and culture.

Furthermore, although Rules 13a-15 and 15d-15 do not contain a reasonableness standard, the applicability of such a standard to financial internal controls required by Section 13(b)(2)(B) and contemplated by the auditing literature⁹ suggests that disclosure controls and procedures also will be held to a reasonableness standard. Section 13(b)(7) of the Exchange Act, which was added to the Exchange Act in 1988, defines that standard as “such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs.”¹⁰

The tools and procedures described subsequently are suggested as a guide to help companies establish disclosure controls and procedures that they can conclude are reasonable and appropriate under the circumstance while, at the same time, being sufficient to ensure compliance with the SEC’s specific and detailed disclosure requirements, so-called line-item materiality. These guidelines do not include suggestions with respect to the establishment of financial internal controls and anticipate that companies will want to incorporate by reference their financial internal controls, and possibly other policies such as codes of conduct and insider trading policies, into the

newly documented disclosure controls and procedures.

Preliminary Steps

1. *Reinforce the Tone at the Top.* The Principal Officers and the audit committee may want to emphasize their commitment to full, fair, accurate, timely, and understandable public disclosures either in the documented disclosure controls and procedures or in other documents, such as the company's code of conduct.
2. *Meet with the Audit Committee.* The audit committee has traditionally been responsible for overseeing financial reporting and financial internal controls. Accordingly, management should consider meeting with the audit committee, and possibly the full board of directors, to discuss the new rules, including the new concept of "disclosure controls and procedures," and to determine the scope of the audit committee's involvement in establishing, maintaining, and evaluating the company's overall disclosure controls and procedures.
3. *Form a Disclosure Controls Committee.* The SEC specifically recommended that each company form a committee to consider the materiality of information and determine disclosure obligations on a timely basis. In addition to the disclosure obligations under the SEC's rules, this committee, referred to herein as the Disclosure Controls Committee, might also be responsible for other disclosures made by the company, including press releases, investor presentations, guidance or other information provided to rating agencies and analysts, answers to analyst or investor questions, and disclosures on the company's Web site. Companies may also want to consider whether the Disclosure Controls Committee should assist the Principal Officers in establishing, maintaining, and evaluating the disclosure controls and procedures, possibly in concert with the audit committee.

Members of the Disclosure Controls Committee might include the principal accounting officer or controller, the general counsel, the principal information systems officer, the principal risk management officer, the investor relations officer, the heads of the company's major business divisions, the senior internal auditor (or a person who performs similar functions) and, in some cases, the Principal Officers themselves. The Disclosure Controls Committee may want to designate specific members to lead the Disclosure Controls Committee's activities, assist the Principal Officers in the ongoing evaluation of the effectiveness of the design and operation of the disclosure controls and procedures (Disclosure Controls Monitor), or monitor any complaints and concerns about, among other things, accounting, auditing, or internal controls received by the company or the audit committee. The Disclosure Controls Committee would report directly to the Principal Officers, if the Principal Officers are not members of the Disclosure Controls Committee, and ultimately to the audit committee.

4. *Review Existing Disclosure Procedures.* The Disclosure Controls Committee's first task should be to review how the financial and non-financial information included in the company's periodic reports and other disclosures has traditionally been gathered, processed, summarized, and reported. The documented

financial internal controls also should be reviewed to determine whether they fully reflect the way in which the company operates its financial internal controls in real time.

5. *Document the Disclosure Controls and Procedures.* A company should document its disclosure controls and procedures. During the documentation process, a company should consider whether to enhance such controls and procedures, including to reflect these guidelines, any new SEC disclosure requirements, and appropriate procedures with respect to foreign operations, less than wholly-owned subsidiaries, and any outsourced activities.¹¹

Procedures to Ensure Timely Disclosure

“Timely” disclosure requires that a company’s disclosure controls and procedures ensure that information from throughout the company is recorded, gathered, processed, summarized, and reported to the appropriate personnel preparing disclosures to investors, and ultimately to the Principal Officers, on a timely basis. It further requires that problems with the design or operation of the disclosure controls and procedures themselves, including any need for changes and any factors that may affect the disclosure controls and procedures (such as significant deficiencies and material weaknesses) are detected, communicated, and addressed promptly. In this regard, companies should consider the following:

1. *Create an “Early Warning System” for Form 8-K Reporting, Press Releases, and Significant Events.* The proposed Form 8-K disclosure rules likely will require companies to report on a Form 8-K, filed within two business days, the occurrence of numerous significant events, as well as in some cases an analysis of the impact on the company.¹² Given the breadth and timing of these proposed new Form 8-K reporting rules, the requirements of the Exchanges and Nasdaq to disclose promptly all material matters, and the need for senior management of the company to be aware of all significant events and circumstances as they occur or are about to occur, companies should consider:

- a) Limiting the number of employees who have the authority to initiate, pursue, and consummate specific activities; and
- b) Identifying a specific employee or employees who will be responsible for (i) monitoring events that may require a Form 8-K filing and (ii) notifying the legal department as soon as possible of an event that may in the future trigger a Form 8-K filing, a press release, or the need for the suspension of trading in the stock of the company (e.g., at the onset of serious negotiations of a material contract not in the ordinary course of business) so that the general counsel can call a meeting of the Disclosure Controls Committee to consider the need for disclosure.

2. *Evaluate Disclosure Controls and Procedures on an Ongoing, Real-Time Basis.* Companies should encourage employees to promptly report to the Disclosure Controls Monitor any problems or breakdowns in the disclosure controls and procedures, including the financial internal controls. The Disclosure Controls Committee should

make any appropriate changes to the disclosure controls and procedures when Committee members become aware of any problems or breakdowns in, or any changes in the company that may impact, the disclosure controls and procedures, such as significant acquisitions or dispositions, changes in personnel, and any other new developments since the date of the last evaluation.

3. *Ensure Awareness of New Rules, Form Changes, and Interpretive Guidance.* The legal and accounting departments should be charged with monitoring new developments at the SEC, the Financial Accounting Standards Board, the Emerging Issues Task Force and other accounting standards setting bodies to identify promptly for the Principal Officers and the Disclosure Controls Committee, as well as to the periodic report drafters and reviewers, any new disclosure or accounting requirements. Companies might also consider providing on-going training about reporting and disclosure obligations to the members of the Disclosure Controls Committee.

Procedures to Ensure Reliable and Accurate Disclosure

Companies need procedures that ensure that the information to be included in SEC reports, press releases, and other disclosures is gathered, processed, summarized, and reported in a reliable and accurate manner. Companies should consider one or more of the following tools to assist in meeting these goals:

1. *Prepare Reporting Timetables.* The Disclosure Controls Committee should prepare one or more timetables that contain the important dates and deadlines for gathering, processing, summarizing, and reporting the information that is required to be disclosed in each of the company's SEC filings, press releases, and other disclosure documents and identify the persons responsible for each of the procedures followed in connection with such processes. Each such timetable should also provide for the final evaluation of the effectiveness of the design and operation of the disclosure controls and procedures.

2. *Prepare Procedures for Drafting Press Releases, Form 8-Ks, and Other Disclosures.* Companies should consider including in the disclosure controls and procedures processes intended to ensure the accuracy and reliability of all press releases, particularly earnings releases, Form 8-Ks, other disclosure documents, investor presentations, Web site disclosures, and answers to analyst and investor questions. Although the early warning system outlined previously should provide the company sufficient time with which to prepare a Form 8-K filing, many of the procedures discussed subsequently may not be practicable for a Form 8-K that is required to be filed within two business days after the triggering event, or for press releases and other types of disclosure documents.

3. *Assign Specific Disclosure-Related Responsibilities to Management and Other Personnel.* The Disclosure Controls Committee might consider assigning to members of management and other personnel clearly articulated responsibilities relating to the preparation of disclosures, including: (a) gathering the information required to be disclosed; (b) preparing specific types of information for disclosure; (c) reviewing draft

disclosure and commenting on the disclosure relating to their areas of responsibility; (d) evaluating the design and operation of the disclosure controls and procedures; (e) providing written sub-certifications as to the accuracy and completeness of the information they provided and the information in the report relating to their area(s) of responsibility; and (f) providing written sub-certifications regarding the effectiveness of, and their compliance with, the design and operation of the company's disclosure controls and procedures.

4. *Implement Tools for Gathering Information.* In addition to any information systems that are used to generate the hard, financial data that is included in the company's financial statements and earnings releases, the Disclosure Controls Committee may want to consider one or more of the following tools for gathering the information that must be included in the company's periodic reports:

- a) **Disclosure Questionnaire.** For purposes of gathering the relevant non-financial information that must be included in the company's periodic reports, the Disclosure Controls Committee might prepare a Disclosure Questionnaire to be completed by appropriate persons. Such a questionnaire could contain plain English summaries of the relevant disclosure requirements for each periodic report and include questions eliciting information regarding the respondent's knowledge with respect to particular disclosure matters and adherence to the company's established disclosure controls and procedures.
- b) **Financial Reporting Questionnaire.** For purposes of gathering the relevant financial statement information that is not generated from an information system, the Disclosure Controls Committee might prepare a Financial Reporting Questionnaire to be completed by appropriate persons. Such a questionnaire could include questions eliciting information regarding the respondent's knowledge with respect to adherence to the company's disclosure controls and procedures, including financial internal controls, and include questions relating to then-current "hot button" issues in financial reporting, such as: (i) critical accounting estimates, and the assumptions underlying them;¹³ (ii) revenue recognition; (iii) non-GAAP financial measures;¹⁴ (iv) non-exchange traded derivatives;¹⁵ (v) impairment determinations; (vi) reserves; (vii) liquidity;¹⁶ (viii) restructuring charges; (ix) changes in pension plan assets; (x) off-balance sheet transactions;¹⁷ and (xi) related-party transactions.¹⁸
- c) **Interviews.** In lieu of or in conjunction with using the questionnaires, the Disclosure Controls Committee may determine to interview employees to discuss disclosure matters.
- d) **Coordination with Audit Committee.** A member of the Disclosure Controls Committee should consult with the audit committee to determine whether the audit committee has received, and how the audit committee is addressing, any complaints or concerns regarding accounting, financial internal controls, or auditing matters pursuant to the procedures that the

audit committee is required to establish under Section 301 of SOA.¹⁹ Any such consultation will have to take into account the requirement that employee concerns regarding questionable accounting and auditing matters be confidential.

- e) Checklist of Documents to Review. Companies must ensure that the disclosures that they are making to the investing public are consistent with both the internal records of the company and other disclosures made by the company. In this regard, the Disclosure Controls Committee should develop a checklist of documents and other sources of information that the drafter, and perhaps a designated member of the Disclosure Controls Committee, should review in connection with the preparation of the draft periodic report. This checklist could include:
- Important company contracts, transactions, and other business or financial changes or developments
 - The company’s press releases during the period
 - Significant industry, analyst, and press reports
 - Financial information and guidance provided to, and answers to questions raised by, analysts, investors, and rating agencies
 - SEC reports and other sources of information relating to competitors
 - The company’s reports to regulatory agencies (other than the SEC), if applicable
 - SEC comment letters on filings
 - Internal audit reports
 - Letters, reports, or suggestions by the outside auditors
 - Any complaints from current employees or concerns of whistleblowers
 - The company’s web site
 - Board of director and board committee minutes and presentations
 - Investor presentations

5. *Prepare the Disclosure in the Periodic Report.* The Disclosure Controls Committee should identify one individual who will work with the identified members of management or other personnel responsible for drafting the various sections of the periodic report and coordinate the preparation of the entire report. The company’s legal department should ensure compliance with all of the current SEC line-item requirements for the specific report. The preparation of the financial statements and other financial data should be done in accordance with the company’s financial internal controls.

In connection with the drafting of the MD&A, the drafter should take into account all of the information collected during the gathering phase described previously, including information about trends, uncertainties, risks, subjective judgments, and

estimates of which investors should be aware. The drafter should also take into account recent guidance by the SEC on drafting the MD&A and should be aware of the then-current hot button issues. The drafter should prepare schedules relating to critical accounting estimates, including the significant assumptions and sources of information underlying them, for use by the Disclosure Controls Committee in discussions with the audit committee and the Principal Officers about the selection and application of such estimates.

6. *Distribute the Draft Periodic Report to the Disclosure Controls Committee for Review.* Once the initial draft of the periodic report is completed and reviewed by the drafters, each member of the Disclosure Controls Committee and other reviewers should review the draft report for accuracy and completeness and with a view to ensuring that the financial statements and other financial information in the report “fairly present” the financial condition, operations, and cash flows of the company.²⁰ After each reviewer has reviewed the report, the Disclosure Controls Committee should meet to consider and discuss any comments or questions that the members of the Disclosure Controls Committee or any other reviewers may have.

7. *Obtain and Review Sub-Certifications.* If the company has decided to request that certain individuals execute sub-certifications relating to the disclosure in the report and the effectiveness of, and compliance with, disclosure controls and procedures and financial internal controls, such sub-certifications should be obtained by the Disclosure Controls Committee once the draft report is ready for distribution to the Principal Officers or the outside auditors. The Disclosure Controls Committee should review the sub-certifications, follow up on any questions or exceptions noted, and make any appropriate changes in the draft report.

Evaluation of Disclosure Controls and Procedures

1. *Nature of Evaluation.* The Disclosure Controls Committee, guided by the Disclosure Controls Monitor, should review and evaluate the effectiveness of the design and operation of the company’s disclosure controls and procedures during the most recent period to determine whether or not such procedures resulted in timely, accurate, and reliable reporting, or otherwise displayed any significant deficiencies or material weaknesses. The Disclosure Controls Committee may decide to begin this process prior to the company’s release of earnings. That review could include the following matters: (a) any breakdowns in the company’s “early warning system;” (b) any gaps between the information included in the draft periodic report and the information included in the checklist of documents reviewed during the gathering and review stages; (c) any sub-certifications relating to disclosure controls and procedures and financial internal controls; (d) reports of the internal auditors and outside auditors; (e) any complaints regarding the financial internal controls; (f) responses to the questionnaires; and (g) discussions with those involved in the functioning of the disclosure controls and procedures and financial internal controls.

2. *Annual Versus Quarterly Evaluation.* Because a full assessment of the financial internal controls will be required once a year in connection with the company’s

annual report once the SEC adopts the rules required by Section 404 of SOA²¹, the company's evaluations of financial internal controls in connection with the filing of a quarterly report may take more of an "exception-based" approach.²² The evaluation of financial internal controls in connection with a quarterly report should focus on identifying (through the materials and sources referred to previously, and the techniques suggested subsequently) any significant deficiencies or material weaknesses in the financial internal controls.²³

3. *Use of Analytics.* Consideration should also be given to making use of the analytics normally employed by outside auditors in connection with the annual audit, such as:

- a) Comparing actual results or balances to predicted or budgeted results or balances and to the results or balances from prior periods;
- b) Examining whether interrelated results and balances are consistent (*e.g.*, whether the amounts for accounts receivable are consistent with the amounts for sales and receipts);
- c) Comparing the ratios between accounts to the ratios from prior periods (for example, whether the inventory turnover ratio is consistent with prior periods); and
- d) Comparing such ratios in the current period to those experienced by other businesses in the same industry.

To the extent that these analytics reveal an anomaly or significant inconsistency with prior periods or the experience of similar businesses, the evaluation must then include an examination into whether such anomaly or inconsistency was the result of a breakdown in the financial internal controls, or was in fact the result of changes in the company's financial performance.

Final Steps

1. *Complete a Documentation File.* The Disclosure Controls Committee should document the preparation process for a given periodic report, such as by drafting memoranda to be included in a file relating to the dates and times of meetings, the participants at those meetings, the internal or external sources of information for statistical and other data, and any feedback on how to modify the process and improve the disclosure controls and procedures. Depending on the circumstances, the Disclosure Controls Committee may want to document substantive areas of concern and how they were resolved. Finally, the Disclosure Controls Committee should keep a specific record of its evaluation of the disclosure controls and procedures.

2. *Discuss the Disclosure Controls Committee's Findings with the Principal Officers.* This discussion should be held among members of the full Disclosure Controls Committee and may involve participation by outside counsel and the outside auditors. The Principal Officers may want to review the documentation of the Disclosure Controls Committee's process and also may want to consider one-on-one meetings with certain

members of the Disclosure Controls Committee (*e.g.*, the senior internal auditor, the Disclosure Controls Monitor, questionnaire respondents, interviewees, drafters, and reviewers) to encourage open and frank discussions.

3. *Meet with the Outside Auditors.* After the Principal Officers have met with the Disclosure Controls Committee, the Disclosure Controls Committee should deliver a draft of the report to the outside auditors for their review and comment. Management, including the Principal Officers, or the Disclosure Controls Committee may then want to meet with the outside auditors to discuss the Disclosure Controls Committee's findings, focusing on financial and accounting issues such as: (a) whether the financial statements and financial information in the report "fairly present" the financial condition, results of operations, and cash flows of the company; (b) any SAS 61 matters; (c) management letters; (d) current accounting issues; and (e) any significant deficiencies in the design or operation of the financial internal controls that could adversely affect the company's ability to record, process, summarize, and report financial information, and any material weaknesses uncovered in the most recent evaluation of the financial internal controls.

4. *Meet with the Audit Committee and the Board.* After reflecting any comments by the outside auditors, the Principal Officers should circulate a revised draft of the periodic report to the members of the audit committee for their review and comment. The Principal Officers should then meet with the members of the audit committee to discuss the draft report. The audit committee also should meet separately with the outside auditors and the senior internal auditor without the presence of the Principal Officers. If the draft report is an annual report on Form 10-K, the Principal Officers should provide a copy of the draft to the board of directors once the audit committee is satisfied with the draft and discuss the report with the board.

5. *Report with Respect to Financial Internal Controls.* The Principal Officers are specifically required to report to the audit committee and the outside auditors any significant deficiencies, including any material weaknesses, in the design or operation of the financial internal controls which could adversely affect the company's ability to record, process, summarize, and report financial data, and any fraud, whether or not material, that involves management or other employees who have a significant role in the company's financial internal controls.²⁴

6. *Complete Final Evaluation of Disclosure Controls and Procedures.* The Disclosure Controls Committee might convene a final meeting prior to the filing of the report to complete its evaluation of the effectiveness of the design and operation of the disclosure controls and procedures to enable the Principal Officers to give their required certifications and to fix the date of the "evaluation" on which the current Item 307 disclosure will be based.

7. *Sign-Off on Disclosure in the Periodic Report and Execute Principal Officer Certifications.* Assuming there are no outstanding issues arising from the audit committee, board of directors or final Disclosure Controls Committee meeting, the periodic report should be finalized. The Disclosure Controls Committee should then

deliver the final periodic report, together with the documentation file for the periodic report and the execution copies of the certifications, to the Principal Officers, who should then sign their respective certifications.

Conclusion

Although many of these suggested procedures may be delegated to members of senior management and will not involve the Principal Officers directly, adequate disclosure controls and procedures must include significant involvement by a company's Principal Officers. In addition, while the additional procedures to *evaluate* the disclosure controls and procedures, including the financial internal controls, initially may be delegated to the Disclosure Controls Committee, the Principal Officers are primarily responsible for implementing and overseeing these quarterly evaluations.

The amount of time and resources that companies need to dedicate to the process of documenting and evaluating their disclosure controls and procedures is likely to be high, and Principal Officers may complain of the added demands on their time.²⁵ Principal Officers should take note of the SEC's view that "any senior corporate official who considers his or her personal involvement in determining the disclosure to be presented in quarterly or annual reports to be an 'administrative burden,' rather than an important or paramount duty, seriously misapprehends his or her responsibility to security holders."²⁶

If you have any questions or require more information, please contact the author of this White Paper, Linda Griggs, at 202.739.5245 or lgriggs@morganlewis.com or another member of our securities practice listed below.

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¹ Release No. 33-8124 (August 28, 2002) (Adoption Release).

² Although the certifications themselves are required only in the company's periodic reports, the disclosure controls and procedures must also cover the preparation of disclosure in the company's current reports (Form 8-Ks and Form 6-Ks for foreign private issuers), definitive proxy or information statements, and other reports that are filed under the Exchange Act. As discussed subsequently, companies should also consider extending their disclosure controls and procedures to cover press releases, particularly earnings releases.

³ The SEC has proposed to revise Rules 13a-14, 13a-15, 15d-14 and 15d-15 to, among other things, require management, including the Principal Officers, to evaluate the company's internal controls and procedures for financial reporting as well as the disclosure controls and procedures, and to conduct such evaluations as of the end of the period covered by the report. *See* Release No. 33-8138 (October 22, 2002) (404 Proposal Release).

⁴ The SEC has proposed a definition of internal controls. *See* 404 Proposal Release.

⁵ The SEC explained in the Adoption Release that it had defined disclosure controls and procedures "to differentiate this concept of disclosure controls and procedures from the pre-existing concept of 'internal controls' that pertains to an issuer's financial reporting and control of its assets, as currently embodied in Section 13(b) of the Exchange Act." Adoption Release, at 8. A contrary conclusion is suggested by the 404 Proposal Release, which proposes rules to implement Section 404 of the Sarbanes-Oxley Act of 2002 (SOA), requiring management's annual report on internal controls. The SEC stated in the 404 Proposal Release that its

rules currently do not require the company's principal executive and financial officers, or the company itself, to conduct periodic evaluations of the company's internal controls.

404 Proposal Release, at 24. In contrast, however, the SEC's discussion in Section III of the 404 Proposal Release under the caption "Paperwork Reduction Act" stated that the evaluation of disclosure controls and procedures will include "a significant portion of internal controls and procedures for financial reporting." 404 Proposal Release, at 29.

⁶ "Division of Corporation Finance: Sarbanes-Oxley Act of 2002 – Frequently Asked Questions" (Nov. 8, 2002, revised on Nov. 14, 2002), at Answer to Question 22.

⁷ The SEC stated in the 404 Proposal Release that it believed that the purpose of internal controls and procedures for financial reporting is to ensure that companies have processes designed to provide reasonable assurance that: the company's transactions are properly authorized; the company's assets are safeguarded against unauthorized or improper use; and the company's transactions are properly recorded and reported to permit the preparation of the registrant's financial statements in conformity with generally accepted accounting principles.

404 Proposal Release, at 22. It said that it believed "that these objectives are embodied in the definition of the term 'internal controls' as the term is defined in the AICPA's Codification of Statements on Auditing Standards (AU) Section 319. . . ." *Id.* AU Section 319 identifies internal controls as a process "designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (a) reliability of financial reporting, (b) the effectiveness and efficiency of operations, and (c) compliance with applicable laws and regulations." The SEC's plain English articulation of the objectives of "internal controls and procedures for financial reporting" in the 404 Proposal Release seems to disregard the objectives in (b) and (c) of AU Section 319 except in so far as they relate to the safeguarding of assets for the proper preparation of financial statements.

⁸ The 404 Proposal Release contemplates that the requirements for such reports on financial internal controls will become effective no sooner than for fiscal years ending on or after September 15, 2003.

⁹ *Supra*, note 7.

¹⁰ The SEC explained in a 1981 release that the reasonableness standard in Section 13(b)(2)(B) of the Exchange Act requires that management be given appropriate deference in designing its financial internal controls and be permitted to balance principles of risk and reward and costs and benefits in designing such controls. The SEC noted:

Reasonableness, as a standard, allows flexibility in responding to particular facts and circumstances. Inherent in this concept is a toleration of deviations from the absolute. One measure of the reasonableness of a system relates to whether the expected benefits from improving it would be significantly greater than the anticipated costs of doing so. Thousands of dollars

ordinarily should not be spent conserving hundreds. Further, not every procedure which may be individually cost-justifiable need be implemented; [Section 13(b)(2)(B)] allows a range of reasonable judgments.

See SEC Release No. 34-17500 (January 29, 1981), which was based on a speech by former SEC Chairman Harold M. Williams on the topic of the then recently enacted financial internal control requirements of Section 13(b)(2)(B) of the Exchange Act.

¹¹ Such procedures may necessitate appropriate representations and warranties in outsourcing agreements to permit the evaluation of the procedures.

¹² These events include: (1) entry into or termination of a material agreement not in the ordinary course of business; (2) termination of a significant business relationship; (3) creation, or the triggering, of a direct or contingent material financial obligation; (4) the decision to recognize material write-offs, restructuring charges, and impairments; (5) rating agency decisions; and (6) listing problems. See Release No. 33-8106 (June 17, 2002).

¹³ See Release Nos. 33-8040 (Dec. 12, 2001) and 33-8098 (May 10, 2002).

¹⁴ The SEC's recent release proposing rules to implement Section 401(b) of SOA uses the term non-GAAP financial measures instead of pro forma financial data. See Release No. 33-8145 (Nov. 4, 2002). See also Release No. 33-8039 (Dec. 4, 2001).

¹⁵ See Release No. 33-8056 (Jan. 22, 2002).

¹⁶ *Id.*

¹⁷ *Id.* See also, Release No. 33-8144 (Nov. 4, 2002).

¹⁸ See Release No. 33-8056 (Jan. 22, 2002).

¹⁹ Under Section 301 of SOA, by April 25, 2003, the SEC must adopt rules that require the Exchanges and Nasdaq to delist any company not in compliance with the requirements, among others, that its audit committee establish procedures for the receipt and handling of complaints received by the company relating to accounting, auditing, and internal controls matters and the confidential, anonymous submission of employee concerns about accounting and auditing matters.

²⁰ In the SEC's view, the "fair presentation" of financial information requires the "selection . . . and 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 disclosure necessary to provide investors with a materially accurate and complete picture of [the company's] financial condition, results of operations and cash flows." Adoption Release, at 61.

²¹ See 404 Proposal Release.

²² The rule amendments included in the 404 Proposal Release equate the quarterly evaluation with the annual evaluation. If the SEC adopts these proposals, the exception-based approach described herein will not be acceptable.

²³ The term significant deficiency is used in the auditing literature to describe a deficiency "in the design or operation of internal control, which could adversely affect the organization's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements." This usage appears in the definition of reportable conditions in AU Section 325.02. The auditing literature defines a material weakness as a significant deficiency in . . . the design or operation of one or more of the internal control components [that] does not reduce to a relatively low level the risk that misstatements caused by error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions."

²⁴ See Rules 13a-14(b)(5) and 15d-14(b)(5).

²⁵ Ironically, in the Adoption Release, the SEC stated that it did not expect that the new disclosure controls and procedures requirements in Rules 13a-15 and 15d-15 would result in any reporting or cost burden associated with the preparation of periodic reports because it expected that "issuers already maintain procedures, whether formal or informal, to comply with their Exchange Act disclosure obligations and for their own internal purposes."

²⁶ See Securities Exchange Act Release No. 46079 (June 14, 2002), at 4.