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SEC ISSUES FINAL RULES REGARDING ANNUAL INTERNAL CONTROL REPORT AND CEO/CFO CERTIFICATIONS

By Richard P. Wolfe and Amos J. Oelking, III

On June 5, 2003, the SEC issued its final rules under Section 404 of the Sarbanes-Oxley Act of 2002 requiring companies to include an annual internal control report in their Forms 10-K. *(Click here to link to our E*Zine regarding the SEC's proposed annual internal control report rules.)* The final rules also require companies, on a quarterly basis, to evaluate and disclose any material changes that have occurred in their internal controls over financial reporting.

Also on June 5, 2003, the SEC issued its final rules requiring issuers to include the CEO and CFO certifications required by Sections 302 and 906 of the Act as exhibits to their Exchange Act periodic reports. *(Click here to link to our E*Zine regarding the SEC's proposed rules regarding exhibit disclosure of the Section 302 and 906 certifications.)* The final rules also revise the content of the Section 302 certification to reflect the June 5, 2003 rules regarding internal controls over financial reporting and disclosure controls and procedures. *(Click here to link to the SEC's release regarding the final internal control and certification rules.)*

Annual Internal Control Report

The SEC's final rules require companies to include a report of management on the company's "internal control over financial reporting"[1] in their Forms 10-K. The report must include:

- a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting;

[1] The SEC's final rules define "internal control over financial reporting" as "[a] process designed by, or under the supervision of, the registrant's principal executive and principal financial officers, or persons performing similar functions, and effected by the registrant'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: (1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets

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- management's assessment of the effectiveness of the company's internal controls as of the end of the company's most recent fiscal year;
- a statement identifying the framework used by management in its assessment; and
- a statement that the company's independent auditor has issued an attestation report regarding management's evaluation.

Management's Assessment of Internal Control

Management's assessment of the company's internal control over financial reporting must

- state whether or not the company's internal controls are effective; and
- disclose any "material weaknesses" identified by management.

Management may not conclude that a company's internal controls are effective if one or more material weaknesses have been identified.

Assessment Procedures

The final rules do not specify the procedures to be used by management in conducting its evaluation; the SEC acknowledges in its release regarding the final rules that the procedures for conducting evaluations will and should vary by company. However, in conducting an evaluation, management must maintain documentation and other evidence to support its assessment of the effectiveness of the company's internal controls. Moreover, management cannot delegate its responsibility to conduct the evaluation to the company's independent auditor.

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of the registrant; (2) 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 registrant are being made only in accordance with authorizations of management and directors of the registrant; and (3) Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the registrant's assets that could have a material effect on the financial statements."

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Assessment Framework

Under the SEC's final rules, the framework to be used by management in conducting its evaluation must be a "suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment." Although the framework set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) satisfies the SEC's criteria, the final rules do not require the use of a particular framework.

Attestation Report of Auditor; Location of Management's Report

The SEC's final rules require that the independent auditor's attestation report be filed as a part of the company's 10-K.

While the final rules do not specify where management's report should appear in the company's 10-K, in its final rules release the SEC states that is "important" for management's report to be in "close proximity" to the auditor's attestation report.

Quarterly Evaluation and Disclosure

The SEC's final rules also require management, on a quarterly basis, to

- evaluate any change in the company's internal control over financial reporting that occurred during the quarter that has materially affected, or is reasonably likely to materially affect, the company's internal controls; and

- disclose such change in the company's Form 10-Q for the quarter in which the change occurred, or in the company's 10-K in the case of a change occurring in the company's last fiscal quarter.

While the final rules do not require companies to disclose the reasons for, or any details regarding, the change, management should consider whether such information constitutes material information, the disclosure of which would be necessary to make the company’s disclosure regarding the change not misleading.

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Filing of Section 302 and 906 Certifications

Consistent with the proposed rules issued in March 2003, the SEC's final rules require companies to file their Section 302 and 906 certifications as Exhibits 31 and 32, respectively, to the Exchange Act periodic reports to which they relate.

Under the final rules, Section 302 certifications will continue to be considered "filed" with the SEC. Section 906 certifications will continue to be considered "furnished," and thus will not be subject to liability under Section 18 of the Exchange Act and will not automatically be incorporated by reference into the company's registration statements.

Modifications to Section 302 Certification

In connection with the adoption of the final rules regarding internal controls, the SEC made certain changes to the Section 302 certification, including the addition of a statement that the CEO and CFO are responsible for either designing the company's internal control over financial reporting or having the controls designed under their supervision.

The SEC's modifications to the Section 302 certification also

- amend the portion of the certification relating to changes in internal controls to refer to changes that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting;
- clarify that a company's *disclosure* controls and procedures may be designed under the supervision of the CEO and CFO;
- clarify that management's conclusions regarding the effectiveness of the company's *disclosure* controls and procedures be as of the end of the period covered by the 10-Q or 10-K; and
- make certain organizational changes to the certification.

The Section 302 certification, as amended, is included in the SEC's final rules release, a hyperlink to which is included above.

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Compliance Dates

Annual Internal Control Report and Auditor Attestation Report

Companies that are "accelerated filers" must include the management internal control report and auditor attestation report in their 10-Ks beginning with the 10-K for their first fiscal year ending on or after June 15, 2004. Companies that are not accelerated filers must include the reports in their 10-Ks beginning with the 10-K for their first fiscal year ending on or after April 15, 2005.

Quarterly Evaluation and Disclosure of Material Internal Control Changes

Companies must make the quarterly *evaluation* of material internal control changes beginning with their first 10-Q due after their first 10-K that must include the management internal control and auditor attestation reports.

However, companies must make the quarterly *disclosure* of any material internal control changes beginning with their first 10-Q or 10-K due on or after August 14, 2003.

Filing of CEO/CFO Certifications; Modifications to Section 302 Certification

Companies must begin filing the Section 302 and 906 certifications as Exhibits 31 and 32, respectively, to their periodic reports beginning with their first 10-Q or 10-K due on or after August 14, 2003.

Except for the additional statement regarding the CEO and CFO's responsibility for designing the company's internal controls, the modifications to the Section 302 certification discussed above must be included in the Section 302 certification filed with the company's first 10-Q or 10-K due on or after August 14, 2003.

The additional statement regarding the CEO and CFO's responsibility for designing the company's internal controls must be included in the Section 302 certification accompanying the company's first 10-K that is required to include the management internal control report, and in each Section 302 certification thereafter.

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GOVERNOR FOSTER SIGNS LEGISLATION OVERRULING *SWAT 24* DECISION

By Carl C. Hanemann and Amos J. Oelking, III

On June 18, 2003, Governor Foster signed into law legislation that overrules the Louisiana Supreme Court's decision in *SWAT 24 Shreveport Bossier, Inc. v. Bond* and its progeny, including the April 2003 decision of the Louisiana Fifth Circuit Court of Appeal in *Richard Berry & Associates, Inc. v. John Bryant, et al.*

The SWAT 24 and Berry Decisions

The *Swat 24* and *Berry* decisions addressed the issue of the enforceability of agreements not to compete under Louisiana Revised Statutes 23:921. In *Swat 24*, the Louisiana Supreme Court held that a non-competition agreement between an employer and an employee can be enforced only in the case where the employee carries on or engages *in his own business* in competition with the former employer, and cannot be enforced in the much more frequently occurring case where the employee becomes *an employee of a business* competing with the former employer. Similarly, in *Berry*, the Louisiana Fifth Circuit Court of Appeal, relying on *SWAT 24*, held that non-competition agreements between independent contractors and the persons with whom they contract are unenforceable in cases where the independent contractor subsequently goes to work (in this case, apparently as an independent contractor) for another competing company. *(Click here to link to our E*Zine discussing the SWAT 24 and Berry decisions in further detail.)*

The New Legislation

House Bill Number 1770, which becomes effective August 15, 2003, amends Louisiana Revised Statutes 23:921 to provide that an employee, a seller of a business, or an independent contractor who becomes "employed" by a competing business may be deemed to be "carrying on or engaging in a business similar to that of the party having a contractual right to prevent that person from competing," regardless of whether the employee, seller, or independent contractor is an owner of the competing business.

As a result, employers, buyers of businesses, and parties who retain independent contractors will be able to enforce non-competition agreements, via actions for injunctive relief or monetary damages, in cases where the

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employee, seller, or independent contractor subsequently becomes an *employee* of a competing business. The use of the term "employee" in the amended statute leaves open the question whether non-competition agreements will be enforceable in cases where the employee, seller, or independent contractor subsequently goes to work for a competing business in a *non-employee* capacity, for example, as a director, independent contractor, or consultant, although a distinction between employees and non-employees for these purposes is not supported by any apparent policy.

The new legislation does not directly affect the sections of Louisiana Revised Statutes 23:921 dealing with partnership and franchise agreements or the provisions regarding computer programmers. *(Click here to link to the full text of House Bill Number 1770 as signed by Governor Foster.)*

Please remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues you may contact the head of our Corporate and Securities practice group:

Curtis R. Hearn
Jones Walker
201 St. Charles Ave., 51st Fl.
New Orleans, LA 70170-5100
phone: 504.582.8308
email: chearn@joneswalker.com

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