

SEC PROPOSES RULES REGARDING ANNUAL INTERNAL CONTROL REPORT AND FINANCIAL EXPERT AND CODE OF ETHICS DISCLOSURE

By Dionne M. Rousseau and Celeste E. Rasmussen

On October 22, 2002, the SEC released proposed rules under Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002 (the "Act") that would require public companies to include a number of new disclosures in their Exchange Act filings: (1) a new annual internal control report, (2) whether they have adopted a code of ethics for senior financial officers, and (3) the names of the "financial experts" on their audit committee. The proposed rules would also amend the CEO/CFO certification under Section 302 of the Act to add a separate certification regarding the evaluation of internal controls and procedures for financial reporting.

Annual Internal Control Report

The rules proposed by the SEC under Section 404 of the Act would require public company annual reports on Form 10-K to contain a new "annual internal control report" by management. Each company's independent auditor would be required to attest to and report on management's report.

The report must include:

- a statement of management's responsibilities 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 as of the end of the company's most recent fiscal year; and
- a statement that the company's independent auditor has attested to, and reported on, management's evaluation.

The attestation and report on management's evaluation by the com-

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ANTITRUST & TRADE REGULATION
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BANKRUPTCY, RESTRUCTURING &
CREDITORS-DEBTORS RIGHTS
BUSINESS & COMMERCIAL
LITIGATION
COMMERCIAL LENDING & FINANCE
CONSTRUCTION
CORPORATE & SECURITIES
EMPLOYEE BENEFITS, ERISA, &
EXECUTIVE COMPENSATION
ENERGY
ENVIRONMENTAL & TOXIC TORTS
ERISA, LIFE, HEALTH &
DISABILITY INSURANCE LITIGATION
GAMING
GOVERNMENT RELATIONS
HEALTH CARE LITIGATION,
TRANSACTIONS & REGULATION
INTELLECTUAL PROPERTY &
E-COMMERCE
INTERNATIONAL
LABOR RELATIONS &
EMPLOYMENT
MEDICAL PROFESSIONAL &
HOSPITAL LIABILITY
MERGERS & ACQUISITIONS
PRODUCTS LIABILITY
PROFESSIONAL LIABILITY
PROJECT DEVELOPMENT & FINANCE
PUBLIC FINANCE
REAL ESTATE: LAND USE,
DEVELOPMENT & FINANCE
TAX (INTERNATIONAL,
FEDERAL AND STATE)
TELECOMMUNICATIONS &
UTILITIES
TRUSTS, ESATES &
PERSONAL PLANNING
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- ADMIRALTY & MARITIME
- ANTITRUST & TRADE REGULATION
- AVIATION
- APPELLATE LITIGATION
- BANKRUPTCY, RESTRUCTURING & CREDITORS-DEBTORS RIGHTS
- BUSINESS & COMMERCIAL LITIGATION
- COMMERCIAL LENDING & FINANCE
- CONSTRUCTION
- CORPORATE & SECURITIES
- EMPLOYEE BENEFITS, ERISA, & EXECUTIVE COMPENSATION
- ENERGY
- ENVIRONMENTAL & TOXIC TORTS
- ERISA, LIFE, HEALTH & DISABILITY INSURANCE LITIGATION
- GAMING
- GOVERNMENT RELATIONS
- HEALTH CARE LITIGATION, TRANSACTIONS & REGULATION
- INTELLECTUAL PROPERTY & E-COMMERCE
- INTERNATIONAL
- LABOR RELATIONS & EMPLOYMENT
- MEDICAL PROFESSIONAL & HOSPITAL LIABILITY
- MERGERS & ACQUISITIONS
- PRODUCTS LIABILITY
- PROFESSIONAL LIABILITY
- PROJECT DEVELOPMENT & FINANCE
- PUBLIC FINANCE
- REAL ESTATE: LAND USE, DEVELOPMENT & FINANCE
- TAX (INTERNATIONAL, FEDERAL AND STATE)
- TELECOMMUNICATIONS & UTILITIES
- TRUSTS, ESATES & PERSONAL PLANNING
- VENTURE CAPITAL & EMERGING COMPANIES
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pany’s independent auditor would also have to be filed with the Form 10-K.

The SEC has proposed to define “internal controls and procedures for financial reporting” as “controls that pertain to the preparation of financial statements for external purposes that are fairly presented in conformity with GAAP, as addressed by the [AICPA’s] Codification of Statements on Auditing Standards §319 [SAS 94] or any superceding definition or other literature that is issued or adopted by the [Accounting Oversight Board].”

If the rules are adopted as proposed, companies with fiscal years ending on or after September 15, 2003 would be required to include the new annual internal control report and the independent auditor attestation in their Form 10-K for fiscal year 2003 and all 10-Ks thereafter.

Financial Expert Disclosure

Section 407 of the Act requires the SEC to adopt final rules by January 26, 2003 requiring public companies to disclose whether their audit committees include at least one member who is a “financial expert” (and, if not, the reasons therefor).

The proposed rules define “financial expert” as a person who has through:

- education and experience as a public accountant or auditor, or a principal financial officer, controller, or principal accounting officer, of a company that, at the time the person held such position, was required to file reports under the Exchange Act

-OR-

- experience in one or more positions that involve the performance of similar functions (or that results, in the judgment of the board of directors, in the person’s having similar expertise and experience)

the following attributes:

- an understanding of generally accepted accounting principles and financial statements;
- experience applying generally accepted accounting principles in connection with the accounting for estimates, accruals, and reserves that are generally comparable to the estimates, accruals, and reserves, if any, used in the company’s financial statements;

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BANKRUPTCY, RESTRUCTURING &
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BUSINESS & COMMERCIAL
LITIGATION
COMMERCIAL LENDING & FINANCE
CONSTRUCTION
CORPORATE & SECURITIES
EMPLOYEE BENEFITS, ERISA, &
EXECUTIVE COMPENSATION
ENERGY
ENVIRONMENTAL & TOXIC TORTS
ERISA, LIFE, HEALTH &
DISABILITY INSURANCE LITIGATION
GAMING
GOVERNMENT RELATIONS
HEALTH CARE LITIGATION,
TRANSACTIONS & REGULATION
INTELLECTUAL PROPERTY &
E-COMMERCE
INTERNATIONAL
LABOR RELATIONS &
EMPLOYMENT
MEDICAL PROFESSIONAL &
HOSPITAL LIABILITY
MERGERS & ACQUISITIONS
PRODUCTS LIABILITY
PROFESSIONAL LIABILITY
PROJECT DEVELOPMENT & FINANCE
PUBLIC FINANCE
REAL ESTATE: LAND USE,
DEVELOPMENT & FINANCE
TAX (INTERNATIONAL,
FEDERAL AND STATE)
TELECOMMUNICATIONS &
UTILITIES
TRUSTS, ESATES &
PERSONAL PLANNING
VENTURE CAPITAL &
EMERGING COMPANIES
WHITE COLLAR CRIME

- experience preparing or auditing financial statements that present accounting issues that are generally comparable to those raised by the company's financial statements;
- experience with internal controls and procedures for financial reporting; and
- an understanding of audit committee functions.

Under the proposed rules, public companies would be required to disclose in each Form 10-K:

- the number and names of persons that the board has determined to be the financial experts serving on the audit committee; and
- whether the financial expert or experts are "independent," as that term is defined in the Act, and, if not, an explanation why they are not.

The proposal also lists eleven factors for boards to consider when making the financial expert determination. The proposal states that although a company's board should consider these factors, they are not a substitute for, and a financial expert must satisfy, all of the attributes in the definition of "financial expert." If a board of directors has determined that a person is a financial expert because of "similar expertise and experience," the basis for that determination must be disclosed. It is not clear from the release when companies must make this disclosure for the first time. Presumably this will be made clear in the SEC's final release.

The Act and the proposed rules can be read to limit financial expertise to individuals who have served as independent auditors or financial executives with direct responsibility for preparing financial statements. If the final rules are that rigid, it is likely that many companies will not have a director who qualifies, and it is possible that finding independent, qualified individuals will be difficult. Although the Act does not require companies to have a financial expert on their audit committee, Nasdaq has proposed to require that audit committees have at least one "financial expert," as defined by the SEC, by the first annual meeting on or after January 1, 2004. The NYSE has not made this proposal.

Code of Ethics for Senior Financial Officers

Section 407 of the Act requires the SEC to adopt rules by

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- BUSINESS & COMMERCIAL LITIGATION
- COMMERCIAL LENDING & FINANCE
- CONSTRUCTION
- CORPORATE & SECURITIES
- EMPLOYEE BENEFITS, ERISA, & EXECUTIVE COMPENSATION
- ENERGY
- ENVIRONMENTAL & TOXIC TORTS
- ERISA, LIFE, HEALTH & DISABILITY INSURANCE LITIGATION
- GAMING
- GOVERNMENT RELATIONS
- HEALTH CARE LITIGATION, TRANSACTIONS & REGULATION
- INTELLECTUAL PROPERTY & E-COMMERCE
- INTERNATIONAL
- LABOR RELATIONS & EMPLOYMENT
- MEDICAL PROFESSIONAL & HOSPITAL LIABILITY
- MERGERS & ACQUISITIONS
- PRODUCTS LIABILITY
- PROFESSIONAL LIABILITY
- PROJECT DEVELOPMENT & FINANCE
- PUBLIC FINANCE
- REAL ESTATE: LAND USE, DEVELOPMENT & FINANCE
- TAX (INTERNATIONAL, FEDERAL AND STATE)
- TELECOMMUNICATIONS & UTILITIES
- TRUSTS, ESATES & PERSONAL PLANNING
- VENTURE CAPITAL & EMERGING COMPANIES
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January 26, 2003 that would require public companies to (1) disclose in their periodic reports whether they have adopted a code of ethics for senior financial officers (and, if not, the reason therefor), and (2) disclose immediately any change in or waiver of the code for senior financial officers.

The SEC's rule proposals explain the disclosure requirements, define the term "code of ethics," and add "principal executive officer" to the list of officers required to be covered by the code. Under the proposed rules, companies would be required to disclose in their Form 10-Ks whether they have adopted a code of ethics for their principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. If a company has not adopted such a code of ethics, it must disclose why not. Each company with an ethics code would also be required to include a copy of the ethics code as an exhibit to its Form 10-K. According to the release, disclosure of a change in or waiver of the code may be made in a Form 8-K filed within two business days after the change or waiver or, alternatively, may be posted on a company's website if the company follows certain procedures. It is not clear from the release when companies must make this disclosure for the first time. Presumably this will be made clear in the SEC's final release.

Revised Civil Certification under Section 302 of the Act

The SEC has also proposed revisions to the Section 302 certification that would specifically require CEOs and CFOs to evaluate and report on the effectiveness of the design and operation of their company's internal controls and procedures for financial reporting on a quarterly basis. The release has created some confusion as to whether quarterly evaluations of internal controls are required currently as part of the quarterly evaluation of disclosure controls and procedures. We believe that internal controls are a part of disclosure controls and procedures. Accordingly, we believe such evaluations are currently required.

If the rules are adopted as proposed, companies with fiscal years ending on or after September 15, 2003 would be required to include the revised certification in their Form 10-K for fiscal year 2003 and all Form 10-Ks and 10-Qs thereafter.

Comments on the proposed rules should be delivered to the SEC no later than November 29, 2002. ([Click here to link to the full text of the SEC's proposal.](#))

SEC PROPOSES RULES PROHIBITING IMPROPER INFLUENCING OF AUDITORS

By Amos J. Oelking III

On October 22, 2002, the SEC proposed rules to prohibit officers and directors of a company from taking any action to fraudulently influence or mislead the auditor of the company's financial statements. The proposed rules, which are mandated by Section 303(a) of the Sarbanes-Oxley Act of 2002, would supplement the existing rules under Regulation 13B-2 of the Securities Exchange Act of 1934.

Specifically, the proposed rules would prohibit officers and directors, and persons acting under their direction, from taking any action to fraudulently influence or mislead an accountant engaged in an audit or review of the company's financial statements. The SEC believes the phrase "engaged in the performance of an audit" set forth in Section 303(a) of the Act should be given a "broad reading." Accordingly, the proposed rules would apply not only throughout the term of a company's engagement of its auditors, but also:

- after the engagement has ended, when the auditor is considering whether to reissue, withdraw, or consent to the use of prior audit reports; and
- prior to the commencement of the professional engagement, when the company is seeking to retain an accounting firm for the audit of its financial statements.

The conduct of an officer, director or person acting under the direction of an officer or director would violate the proposed rules if such person knew, or was unreasonable in not knowing, that such conduct could, if successful, result in the company's financial statements being materially misleading. Moreover, such conduct would violate the proposed rules even if the conduct is not successful in affecting the audit or review. Examples of prohibited conduct under the proposed rules include, but are not limited to, actions taken to fraudulently influence or mislead an auditor:

- not to perform audit, review or other procedures required by generally accepted auditing standards or other professional standards;
- to issue a report on the company's financial statements that is not warranted under the circumstances (for example, due to a

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- ANTITRUST & TRADE REGULATION
- AVIATION
- APPELLATE LITIGATION
- BANKRUPTCY, RESTRUCTURING & CREDITORS-DEBTORS RIGHTS
- BUSINESS & COMMERCIAL LITIGATION
- COMMERCIAL LENDING & FINANCE
- CONSTRUCTION
- CORPORATE & SECURITIES
- EMPLOYEE BENEFITS, ERISA, & EXECUTIVE COMPENSATION
- ENERGY
- ENVIRONMENTAL & TOXIC TORTS
- ERISA, LIFE, HEALTH & DISABILITY INSURANCE LITIGATION
- GAMING
- GOVERNMENT RELATIONS
- HEALTH CARE LITIGATION, TRANSACTIONS & REGULATION
- INTELLECTUAL PROPERTY & E-COMMERCE
- INTERNATIONAL
- LABOR RELATIONS & EMPLOYMENT
- MEDICAL PROFESSIONAL & HOSPITAL LIABILITY
- MERGERS & ACQUISITIONS
- PRODUCTS LIABILITY
- PROFESSIONAL LIABILITY
- PROJECT DEVELOPMENT & FINANCE
- PUBLIC FINANCE
- REAL ESTATE: LAND USE, DEVELOPMENT & FINANCE
- TAX (INTERNATIONAL, FEDERAL AND STATE)
- TELECOMMUNICATIONS & UTILITIES
- TRUSTS, ESATES & PERSONAL PLANNING
- VENTURE CAPITAL & EMERGING COMPANIES
- WHITE COLLAR CRIME

- ADMIRALTY & MARITIME
- ANTITRUST & TRADE REGULATION
- AVIATION
- APPELLATE LITIGATION
- BANKRUPTCY, RESTRUCTURING & CREDITORS-DEBTORS RIGHTS
- BUSINESS & COMMERCIAL LITIGATION
- COMMERCIAL LENDING & FINANCE
- CONSTRUCTION
- CORPORATE & SECURITIES
- EMPLOYEE BENEFITS, ERISA, & EXECUTIVE COMPENSATION
- ENERGY
- ENVIRONMENTAL & TOXIC TORTS
- ERISA, LIFE, HEALTH & DISABILITY INSURANCE LITIGATION
- GAMING
- GOVERNMENT RELATIONS
- HEALTH CARE LITIGATION, TRANSACTIONS & REGULATION
- INTELLECTUAL PROPERTY & E-COMMERCE
- INTERNATIONAL
- LABOR RELATIONS & EMPLOYMENT
- MEDICAL PROFESSIONAL & HOSPITAL LIABILITY
- MERGERS & ACQUISITIONS
- PRODUCTS LIABILITY
- PROFESSIONAL LIABILITY
- PROJECT DEVELOPMENT & FINANCE
- PUBLIC FINANCE
- REAL ESTATE: LAND USE, DEVELOPMENT & FINANCE
- TAX (INTERNATIONAL, FEDERAL AND STATE)
- TELECOMMUNICATIONS & UTILITIES
- TRUSTS, ESATES & PERSONAL PLANNING
- VENTURE CAPITAL & EMERGING COMPANIES
- WHITE COLLAR CRIME

material violation of generally accepted accounting principles); or

- not to communicate matters to the company's audit committee.

Comments on the proposed rules should be delivered to the SEC no later than November 25, 2002. ([Click here to link to the full text of the SEC's proposal.](#))

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:

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