



Sarbanes-Oxley Act of 2002 and Related SEC Rulemaking

Implementation Reference Guide

July 2003 Edition



BDO Seidman, LLP
Accountants and Consultants
www.bdo.com



SARBANES-OXLEY ACT OF 2002 AND RELATED SEC RULEMAKING

July 2003

Dear Clients and Friends:

As you well know, in a flurry of activity, the SEC has proposed and adopted new rules to implement a number of the provisions of the Sarbanes-Oxley Act of 2002 (the Act). This avalanche of rules has created the daunting task of sorting through each of the SEC's releases to determine whether the rules have been adopted, what they require and when they are effective. This is made even more difficult by the fact that a number of the releases individually exceed 100 pages in length.

Many of our clients have told us, "It would be good to have all this in one place." In response, we have prepared this Implementation Reference Guide. It summarizes the Act and associated proposed and final SEC rules. It also provides observations regarding interpreting and implementing those rules. We hope it will help provide you with the key points you need to know about the over 1,000 pages of materials that it summarizes.

The table of contents should help you find guidance on a particular subject (e.g., code of ethics). Section 1 summarizes various sections of the Act by body or group affected (e.g., officers and directors, audit committee, etc.). In that summary, we have provided references to the related sections of this guide that cover SEC rulemaking to implement those sections of the Act.

This guide is current as of July 15, 2003. It has been updated to cover rules the SEC recently adopted that cover the following matters:

- Standards Relating to Listed Company Audit Committees
- Improper Influence on Conduct of Audits
- Mandated Electronic Filing and Website Posting for Forms 3, 4 and 5
- Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports

Page ii provides a list of the changes we have made to the previous (March 20, 2003) edition.

For an expanded description of the rules, we direct you to our *Financial Reporting* letters. You can find them at the following address on our website:

<http://www.bdo.com/about/publications/assurance/>

However, as you implement the rules, you should work from the final rules as published by the SEC and not rely solely on this guide or these letters.



SARBANES-OXLEY ACT OF 2002 AND RELATED SEC RULEMAKING

If you would like more information or have questions regarding these rules or proposals, please contact the BDO Seidman, LLP engagement partner serving you or one of the following partners:

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Sincerely,

BDO Seidman, LLP



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Material discussed in this Reference Guide is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual facts and circumstances.

Summary of Changes

Below is a list of the changes we have made to the previous (March 20, 2003) edition of this guide:

- We have used a new numbering scheme for the content of each section. However, the content remains the same, except as indicated below.
- We have re-written the following sections to cover new final SEC rules:
 - Section 3 (Standards Relating to Listed Company Audit Committees)
 - Section 5 (Improper Influence on Conduct of Audits)
 - Section 11 (Mandated Electronic Filing and Website Posting for Forms 3, 4 and 5)
 - Section 12 (Management’s Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports)
- We have updated sections 1 (items 2.a and 2.b) and 4 (items 4, 5 and 10) to refer to new rules that change the content of the Section 302 certifications and require that they be filed or furnished as exhibits, as discussed in section 12.
- We have updated section 2 (item 5) to note the item number corrections to Forms 10-K and 10-KSB reflected in Release No. 33-8183A and the changes subsequently made through the amendments in Release No. 33-8238. We have also updated section 2 (item 42) to discuss implementation considerations related to the audit committee communications rules when an auditor reissues a report after May 6, 2003 that was originally issued before May 6, 2003.
- We have updated section 6 (item 21) and section 9 (item 32) to reflect the interim Form 8-K filing procedures for Items 11 and 12 outlined in Release No. 33-8216.
- We have expanded section 9 (item 4) to refer to a frequently asked questions document (FAQ) issued by the SEC staff. We have also expanded the interpretations based on guidance in the FAQ and discussions with the SEC staff.
- We have updated section 14 (item 4) to note that the SEC has confirmed (in Release No. 33-8177A) that audit committee financial expert disclosures are required only in annual reports. We have also updated section 14 (items 6 and 14.a) to reflect the audit committee independence standards adopted in Release No. 33-8220, which is discussed in section 3.

1. Sarbanes-Oxley Act of 2002 (The Act)

1. Congress gave final approval (House 423-3; Senate 99-0) to the bill on July 25, 2002. President Bush signed it into law on July 30, 2002.
2. The legislation includes the following major items (presented by body or group affected):

Officers and Directors

- a. Section 302 of the Act requires CEOs and CFOs of all registrants (including foreign private issuers and small business issuers) to certify that their annual and quarterly reports are accurate and that they are responsible for establishing, maintaining and periodically evaluating the effectiveness of internal controls (later termed “disclosure controls and procedures”). Rules have been adopted. See section 4 below. Rules that relocated the certifications and require that they be filed as exhibits have been adopted. See section 12 below.
- b. Section 906 of the Act requires a second certification, which did not require SEC rulemaking for implementation. This requirement was effective immediately and applies to all filings on or after July 30, 2002. This requirement mandates that the CEO and CFO certify for each quarterly and annual report that:
 - The report fully complies with the Exchange Act (note that this element does not contain a materiality limitation); and
 - The information in the report fairly presents, in all material respects, the financial condition and results of operations of the company.Rules requiring that these certifications be furnished as exhibits have been adopted. See section 12 below.
- c. Section 404 requires companies to include in their annual reports a management “internal control report” stating management’s responsibility for, and a current assessment of, the effectiveness of controls. Rules have been adopted. See section 12 below.
- d. Bans personal loans from public companies to directors/officers (there are certain exceptions provided, including those for banks). (Section 402)
- e. Prohibits executive officers and directors from trading company securities during any period when a majority of plan participants are prohibited from trading company securities held in company sponsored benefit plans (blackout period). Rules have been adopted. See section 6 below. (Section 306)
- f. Requires companies to disclose whether they have adopted a code of ethics for their senior financial officers and, if not, disclose the underlying reasons. Any change in or waiver of the code must immediately be disclosed in a Form 8-K. See section 13 below. Rules have been adopted. (Section 406)
- g. Makes it unlawful to improperly influence auditors for the purpose of rendering misleading financial statements. Rules have been adopted. See section 5 below. (Section 303)
- h. Increases fines/jail time for corporate fraud/document shredding. Also, bonuses and certain other compensation and securities gains must be returned to the company if the company restates its financial statements due to material noncompliance with financial reporting requirements as a result of misconduct. (Sections 304 and 305, Title VIII)
- i. It is the “sense” of Congress that the company’s Federal income tax return should be signed by the CEO.

Audit Committees

- a. Each member must be independent (definition could be different than what the exchanges ultimately adopt). Rules have been adopted. See section 3 below. (Section 301)

- b. Required to disclose whether or not at least one member qualifies as a “financial expert.” Rules have been adopted. See section 14 below. (Section 407)
- c. Responsible for the appointment, compensation and oversight of auditors, including resolution of disagreements between management and the auditors. Rules have been adopted. See section 3 below. (Section 301)
- d. Must establish “whistleblower” procedures concerning accounting, internal control or auditing matters. Rules have been adopted. See section 3 below. (Section 301)
- e. Can engage independent counsel or other advisors, as necessary, with funding provided by the company. Rules have been adopted. See section 3 below. (Section 301)
- f. Permitted services, including tax services, will need to be pre-approved by the audit committee (to be disclosed in periodic reports). Rules have been adopted. See section 2 below. (Sections 201 and 202)
- g. Required to receive reports from the auditors regarding critical accounting policies and practices used in the financial statements. Rules have been adopted. See section 2 below. (Section 204)

Independent Auditors

- a. The Act establishes a new five-member Public Company Accounting Oversight Board (Board or PCAOB); members to be appointed by the SEC; the Board has standards setting authority (auditing, quality control, ethics and independence) and the power to fine and discipline auditors. The Board has been appointed, and on April 25, 2003 the SEC determined that it was appropriately organized and had the capacity to carry out its responsibilities. Accordingly, public accounting firms must register with the Board by October 22, 2003.
- b. The Board must adopt auditing standards requiring outside auditors to issue an attestation report on management’s assessment included in its “internal control report.” See section 12 below. The Auditing Standards Board of the AICPA has proposed standards regarding this new audit requirement.
- c. Requires annual quality reviews of larger accounting firms (including BDO) and every three years for smaller firms.
- d. Restricts consulting and other non-auditing services that auditors may perform (including bookkeeping, information systems design, valuation, actuarial, internal audit, investment and legal and expert services). Permitted services, including tax services, will need to be pre-approved by the audit committee (to be disclosed in periodic reports). Rules have been adopted. See section 2 below. (Sections 201 and 202)
- e. Mandates firms to rotate the lead audit partner and concurring review partner every five years (previously seven for lead audit partner). Rules have been adopted. See section 2 below. (Section 203)
- f. Required to provide reports to audit committees regarding critical accounting policies and practices used in the financial statements. Rules have been adopted. See section 2 below. (Section 204)
- g. Audit firms cannot audit public companies whose CEO, CFO, controller or CAO had worked for the audit firm during the preceding year. Rules have been adopted. See section 2 below. (Section 206)

Lawyers

- a. SEC to issue new rules setting forth certain minimum standards of professional conduct for attorneys practicing before the SEC. Rules have been adopted. See section 7 below. (Section 307)
- b. Requires an attorney to report evidence of material violations of securities law or breach of fiduciary duty by the company to the chief legal counsel (CLO) or the CEO.

- c. Requires an attorney to report these matters to the audit committee if the CLO or CEO does not appropriately respond to the evidence.

Securities Analysts

- a. Rules to be adopted by the SEC to address conflicts of interest between securities analysts and those employed by the broker or dealer who are engaged in investment banking activities. Rules have been adopted. (Section 501)

SEC

- a. At least every three years, the SEC is required to review filings made by each public company with more frequent reviews based upon certain discrete triggers (e.g., material restatements). (Section 408)
- b. The SEC must require disclosure in quarterly and annual reports of material off-balance sheet transactions, arrangements, obligations and certain other relationships with related parties. Rules have been adopted. See section 8 below. (Section 401(a))
- c. Must establish rules over the reporting of pro forma financial information. Rules have been adopted. See section 9 below. (Section 401(b))

2. SEC Rule – Strengthening the Commission’s Requirements Regarding Auditor Independence (Release No. 33-8183 and No. 33-8183A)

1. The rules in this release implement Sections 201, 202, 203, 204 and 206 of the Act which contain auditor independence provisions related to:
 - a. Services outside the scope of the practice of auditors;
 - b. Pre-approval of audit and permitted non-audit services by audit committees;
 - c. Audit partner rotation requirements;
 - d. Auditor communications with audit committees; and
 - e. Employment of audit team members by a client.
2. In addition to the rules mandated by the Act, additional rules prohibit audit partners who work on the audit of a public company from receiving compensation for selling non-audit services to that company. The rules do not preclude an audit partner from sharing in the profits of the audit practice and those of the overall firm. Also, an audit partner’s evaluation can take into account factors related to selling services to an audit client, such as the overall management of the relationship with an audit client, as long as there is no direct link between fees for non-audit services and compensation.
3. The rules also expand the disclosure requirements in annual reports and proxy statements about professional fees the company paid to its principal auditor and require disclosure of any policies and procedures developed by the audit committee concerning pre-approval of audit and non-audit services.
4. All of the rules are applicable to U.S. and foreign registrants, as well as to registered investment companies.
5. The independence rules have been added to Article 2 of Regulation S-X. The SEC also amended the Exchange Act rules under Section 10A to make it clear that violating the independence rules in Regulation S-X also constitutes a violation of the Exchange Act. The rules covering disclosure of accountants’ fees and services have been added to the annual report forms and the proxy rules. This resulted in adding a new item, Principal Accountant Fees and Services, to the annual report forms. The revised item numbers for Forms 10-K and 10-KSB listed in Release No. 33-8183 were incorrect. The Commission corrected them in Release No. 33-8183A. The item numbers were subsequently revised in Release No. 33-8238. See section 12.

6. The rules took effect May 6, 2003. Various transition dates and grandfathering provisions have been provided in the rules concerning non-audit services, audit partner rotation and employment relationships. These are discussed in detail below.

Services Outside the Scope of the Practice of Auditors

7. The rules, which implement Section 201 of the Act, amend the SEC's existing rules on auditor independence contained in Regulation S-X and clarify the provisions of the Act on prohibited non-audit services.
8. Section 201 of the Act lists non-audit services that an audit firm may not perform for its public company audit clients, as noted below. The rules do not limit the scope of non-audit services provided by an accounting firm to a non-audit client.
9. The final rules are based on three basic principles of auditor independence:
 - a. An auditor cannot audit his or her own work;
 - b. An auditor cannot function in the role of management; and
 - c. An auditor cannot act as an advocate for his or her client.
10. The prohibited non-audit services are as follows:
 - a. Bookkeeping or other services related to the accounting records or financial statements of the audit client:
 - All bookkeeping services would impair independence unless it is reasonable to conclude that the results of those services will not be subject to audit procedures. Exceptions in the previous rules were eliminated.
 - The definition of bookkeeping or other services focuses on (1) maintaining or preparing the company's accounting records, (2) preparing financial statements that are filed with the SEC or the information which forms the basis of those financial statements, and (3) originating source data underlying the financial statements.
 - An accountant's independence would be impaired if he or she prepared the statutory financial statements of a foreign subsidiary if those statements form the basis of the financial statements filed with the SEC.
 - b. Financial information systems design and implementation:
 - The rules prohibit the auditor from directly or indirectly operating or supervising the operation of the company's information systems or managing the company's local area network or information systems, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures.
 - The auditor is prohibited from designing and implementing a hardware or software system that aggregates source data underlying the financial statements or generates information that is significant to the company's financial statements taken as a whole. By "significant," the SEC refers to information that is reasonably likely to be material to the financial statements.
 - The auditor would not be prohibited from working on hardware or software systems that are unrelated to the company's financial statements or accounting records as long as those services are pre-approved by the audit committee.
 - The prohibition does not preclude the accountant from evaluating the internal controls of a system as it is being designed, implemented or operated, as part of an audit or attest service and making recommendations to management. The auditor may make recommendations on internal control matters to management in conjunction with the design and installation of a system by another service provider.
 - c. Appraisal or valuation services, fairness opinions or contribution-in-kind reports:
 - The rules prohibit an accountant from providing any appraisal service, valuation service, or any service involving a fairness opinion or contribution-in-kind report for an audit client,

- unless it is reasonable to conclude that the results of these services will not be subject to audit procedures.
- Appraisal and valuation services include valuing, among other things, in-process R&D, financial instruments, assets and liabilities acquired in a merger, and real estate.
 - The rules do not prohibit the auditor from providing such services for non-financial reporting purposes (e.g., transfer pricing studies, cost segregation studies and other-tax-only valuations).
 - The rules do not prohibit the auditor from utilizing its own valuation specialist to review the work done by the company itself or an independent, third-party specialist employed by the company, provided the company or the company's specialist provides the technical expertise that the company uses in determining the required amounts recorded in the company's financial statements.
- d. Actuarial services:
- Previous rules generally barred auditors only from providing actuarial services related to insurance company policy reserves and related accounts.
 - The new rules prohibit an accountant from providing to an audit client any actuarially-oriented advisory service involving the determination of amounts recorded in the financial statements and related accounts for the audit client other than assisting the client in understanding the methods, models, assumptions and inputs used in computing an amount, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures.
 - The SEC believes it is appropriate to advise the client on the appropriate actuarial methods and assumptions that will be used in the actuarial valuations. However, it is not appropriate to perform an actuarial valuation for an audit client.
 - An accountant may utilize his or her own actuaries to assist in conducting the audit provided the audit client uses its own actuaries or third-party actuaries to provide management with its actuarial capabilities.
- e. Internal audit outsourcing services:
- Previous rules permitted a company to outsource part of its internal audit function to its external auditor subject to certain exemptions.
 - The new rules prohibit outsourcing to the auditor internal audit services related to internal accounting controls, financial systems, or financial statements of an audit client unless it is reasonable to conclude that the results of these services will not be subject to audit procedures.
 - Reviewing internal controls and making recommendations for improvements as part of an audit do not constitute an internal audit outsourcing engagement.
 - The proposed rules do not prohibit nonrecurring evaluations of discrete items or programs that are not in substance the outsourcing of the internal audit function. They also do not prohibit operational internal audits unrelated to internal accounting controls, financial systems or financial statements.
- f. Management functions:
- Consistent with previous rules, the new rules prohibit an auditor from acting, temporarily or permanently, as a director, officer or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring functions for the company.
 - The rules continue to allow auditors to assess the effectiveness of internal controls and to recommend improvements in the design and implementation of internal controls and risk management controls. However, designing and implementing internal accounting and risk

- management controls would impair an auditor's independence under the new rules. Providing recommendations to a third party service provider would be permitted.
- An auditor may, subject to audit committee pre-approval, conduct an agreed-upon procedures engagement related to a company's internal controls or to provide attest services related to the company's internal controls without impairing his or her independence.
- g. Human resources:
- Consistent with previous rules, new final rules prohibit an auditor from (1) searching out or seeking out prospective candidates for managerial, executive, or director positions, (2) acting as negotiator on the company's behalf, such as determining position, status, compensation, fringe benefits, or other conditions of employment, or (3) undertaking reference checks of prospective candidates.
 - An auditor is also prohibited from (1) engaging in psychological testing, or other formal testing or evaluation programs, or (2) recommending or advising the company to hire a specific candidate for a specific job.
 - An auditor may interview candidates and advise the client on their competence for financial or administrative positions.
- h. Broker or dealer, investment advisor or investment banking services:
- Previous rules deemed an auditor to lack independence when performing brokerage or investment advisory services for an audit client. The new rules also prohibit an auditor from serving as an unregistered broker-dealer for a client.
- i. Legal services:
- Previous rules deemed an auditor to lack independence when performing legal services for an audit client. The new rules prohibit the auditor from providing any service to the audit client that, under circumstances in which the service is provided, could be provided only by someone licensed, admitted or otherwise qualified to practice law in the jurisdiction in which the service is provided.
 - The rules are not intended to prohibit foreign accounting firms from providing services that an accounting firm in the U.S. may provide. Accordingly, independence would not be impaired if an accountant performed tax services in a foreign jurisdiction where tax services must be performed by someone licensed to practice law.
- j. Expert services unrelated to the audit:
- Previous rules did not prohibit the auditor from providing expert services to an audit client. Under the new rules, the auditor may not provide expert opinions or other services for an audit client for purposes of advocating that client's interests in litigation or regulatory, administrative investigations or proceedings.
 - Prohibited services include being engaged by the audit client's legal counsel to provide expert witness or other services (including accounting advice, opinions or forensic accounting services) in connection with the client's participation in a legal, administrative or regulatory proceeding.
 - The rules do not prohibit an auditor from assisting the audit committee in fulfilling its responsibilities with the financial reporting process (e.g., in conducting its own investigation of a potential accounting impropriety), so long as the auditor does not take on the role of an advocate in the investigation.
 - The rules also do not prohibit an auditor from testifying as a fact witness regarding its audit or tax work for an audit client, or from explaining the positions taken or conclusions reached during the performance of any service provided.
11. With respect to tax services, the Act expressly permits auditors to provide them. In addition, in its release, the Commission confirmed that auditors are not prohibited from providing tax services. The

Commission stated, “The Commission reiterates its long-standing position that an accounting firm can provide tax services to its audit clients without impairing the firm’s independence.”

12. While “tax services” are not defined in the rules, the release states that accountants may continue to provide tax services such as tax compliance, tax planning and tax advice to audit clients, subject to the audit committee pre-approval requirements.
13. The SEC stated that audit committees should “scrutinize carefully” the retention of an accountant in a transaction initially recommended by the accountant, the sole business purpose of which may be tax avoidance and the tax treatment of which may not be supported by the Internal Revenue Code.
14. The Commission stated that tax services involving advocacy, such as representing an audit client before a tax court, district court or federal court of claims, would impair an auditor’s independence.
15. These rules were effective as of May 6, 2003.
16. For contracts in existence as of May 6, 2003, providing previously permitted non-audit services will not impair an accountant’s independence unless they are still being provided after May 6, 2004.

Interpretations and Implementation Considerations

- a. *The new rules do not provide a de minimis exception for prohibited services. Companies and auditors should evaluate and consider strengthening their controls to prevent the auditor from inadvertently providing prohibited non-audit services.*
- b. *For certain services (bookkeeping, financial information systems design and implementation, appraisal or valuation, actuarial, and internal audit outsourcing), the rules state that they are prohibited unless it is “reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the client’s financial statements.” The meaning of this language may require interpretation, since we understand that the SEC staff expects that this condition will rarely be met. Given this view, it appears that companies and auditors should be extremely cautious about concluding that an auditor can perform design or implementation work on a system that generates information that is used in preparing the financial statements.*
- c. *In some foreign jurisdictions, tax services must be provided by a person licensed to practice law, so the person would be deemed to be providing legal services. The rules do not provide exceptions for foreign accounting firms, and the commentary in the release implies that firms should preclear providing these services with the SEC staff. However, we understand that preclearing tax and other services that are clearly permitted by the rules is not necessary.*
- d. *The auditor may assist the audit committee in conducting an investigation, as described above. However, if the matters the auditor investigates subsequently become the subject of a proceeding or investigation, the new rules would prohibit the auditor from providing additional services to legal counsel. In addition, the auditor could be subject to potential claims of conflicts. Audit committees may want to select accountants other than the company’s auditors to perform this work, so that the firm that performs this work will not be limited in the assistance it can provide to legal counsel. Selecting another firm would also avoid the appearance of a lack of independence.*
- e. *The scope of practice limitations apply to all periods for which audited financial statements are presented in a filing. Thus, a company contemplating an IPO must avoid engaging its auditor to perform these services during years for which audited financial statements might appear in a future IPO registration statement.*

Pre-approval of Audit and Permitted Non-audit Services by Audit Committees

17. The new rules, which implement Section 202 of the Act, were adopted substantially as proposed. They require that the audit committee pre-approve all permitted non-audit services and all audit, review or attest services.

18. The rules require that before the accountant is engaged by the issuer to render audit or non-audit services, the engagement is either:
 - a. Approved by the issuer's audit committee; or
 - b. Entered into pursuant to pre-approval policies and procedures established by the audit committee provided (1) the policies and procedures are detailed as to the particular service, (2) the audit committee is informed on a timely basis of each service and (3) such services do not include delegation of the audit committee's responsibilities to management.
19. The rules allow the audit committee to broadly approve the provision of audit, review and attest services by the auditor.
20. The rules define audit services broadly. They include services such as the issuance of comfort letters in connection with securities offerings, as well as services related to statutory audits required by insurance companies and other domestic and international statutory audit requirements.
21. Review of the tax accrual by tax personnel and consultation services provided by "national office" or other technical reviewers to reach an audit judgment are considered to be audit services.
22. In contrast, research and consultation by an accounting firm to evaluate the accounting for a proposed transaction would not be considered to be audit services.
23. The Act allows one audit committee member to pre-approve the services, followed by a presentation of such to the full audit committee at its scheduled meetings.
24. A de minimis exception is provided related to the provision of permitted non-audit services. The pre-approval requirement is waived if:
 - a. The aggregate amount of all such services provided constitutes no more than five percent of the total fees paid to the accountant during the fiscal year in which the services are provided;
 - b. Such services were not recognized at the time of the engagement to be non-audit services; and
 - c. Such services are promptly brought to the attention of the audit committee and approved prior to the completion of the audit by the audit committee.
25. As discussed below, the audit committee's pre-approval policies and procedures must be disclosed in the company's annual report and proxy statement.
26. An investment company's audit committee must pre-approve non-audit services provided directly to the investment company as well as non-audit services provided to an entity in the investment company complex where the nature of the services provided is such that they have a direct impact on the investment company.
27. The pre-approval requirements apply to all contracts for audit, review, and attest services and non-audit services entered into after May 6, 2003. Services previously arranged are not subject to the pre-approval requirements, as long as they are completed by May 6, 2004.

Interpretations and Implementation Considerations

- a. *The rules do not prescribe the degree of specificity with which an audit committee must pre-approve services. We understand, for example, that it would be equally acceptable for an audit committee to approve (1) "2003 state tax return preparation services in all states where the company is required to file such returns" or (2) "2003 state tax return preparation services in the states of New York, Illinois and California."*
- b. *With regard to pre-approval policies and procedures, the SEC provided little guidance on how it expects companies to apply the general requirements discussed above. In the commentary in the release, the Commission referred only to the delegation of audit committee authority permitted by the Act. The Act allows for one or more designated audit committee members who are independent to pre-approve services and requires the decisions of those members to be reported to the full audit committee at each of its scheduled meetings.*

- c. *The SEC noted that although the Act permits an audit committee to pre-approve a service at any time in advance of the activity, it expects that audit committees will establish policies limiting the period in advance of the activity for which the approval may be granted.*
- d. *Other new rules require companies to disclose their pre-approval policies and procedures. We expect that over time best practices for pre-approval policies and procedures will develop.*
- e. *The de minimis exception discussed above applies only to permitted non-audit services. It does not provide for approving an audit service after-the-fact, and it does not provide a de minimis exception for prohibited non-audit services. In addition, the exception is available only if the after-the-fact approval occurs before the completion of the audit. (We understand that an audit is considered completed on the date a company files the auditor's report with the SEC.)*
- f. *Thus, companies and auditors should take extra steps to (1) make sure all audit services are pre-approved, (2) prevent the auditor from inadvertently providing prohibited non-audit services, and (3) identify all non-audit services provided before the company files its financial statements.*
- g. *The fact that the rules view the concept of audit services broadly increases the risk that a service inadvertently performed without pre-approval could be a service for which after-the-fact approval is not permitted. To reduce this risk, audit committees should consider pre-approving audit services broadly. For example, an audit committee might approve "statutory audits in all countries where they are required," rather than "statutory audits in countries A, B, C, and D." In addition, the exercise of preparing the disclosure of the fees paid to the auditor should be completed before a company files its annual report – not deferred until the time the proxy statement is prepared. Doing this would increase the likelihood that de minimis non-audit services inadvertently performed without pre-approval can be approved before the company files its financial statements.*
- h. *The pre-approval requirements apply to an "issuer," as that term is defined in the Exchange Act, or its subsidiaries. Companies that are not SEC registrants do not become issuers until they file a registration statement with the SEC. We understand that the pre-approval requirements do not apply to arrangements for services that are entered into before a company files an initial registration statement. All arrangements entered into after that date must be pre-approved. If a company does not have an audit committee in place, the full board must pre-approve the services.*
- i. *We understand that the pre-approval requirements apply only to principal auditors. They do not apply to other auditors who audit subsidiaries, investees, etc.*

Audit Partner Rotation Requirements

- 28. Section 203 of the Act requires rotation of the lead audit partner and concurring review partner after five years but is silent regarding the "time-out" period. Current requirements of the AICPA's SEC Practice Section call for the lead partner to rotate off after seven years and to remain off for two years.
- 29. The new rules are more rigorous than the rotation rules in the Act but are not as extensive as what was originally proposed. Partners subject to the rotation include:
 - a. The lead audit partner;
 - b. The concurring partner;
 - c. Other "audit partners," a new term defined in the rules.
- 30. Accounting firms with fewer than five audit clients that are issuers and fewer than ten partners are not subject to the rotation requirements, but the PCAOB must review these engagements at least once every three years.
- 31. "Audit partners" include partners on the audit engagement team who (1) have decision-making responsibility on significant auditing, accounting and reporting matters that affect the financial

- statements, or (2) who maintain regular contact with management and the audit committee. This includes:
- a. The lead audit partner;
 - b. The concurring partner;
 - c. Other audit partners who spend more than ten hours serving the client at the issuer or parent level; and
 - d. The lead partner on subsidiaries of the issuer whose assets or revenues constitute 20% or more of the consolidated assets or revenues.
32. Partners assigned to “national offices” (which can include technical accounting and auditing, whether at a local or national level, as well as centralized quality control functions) who may be consulted on specific accounting issues related to a client are not “audit partners” even though they may periodically consult on client matters.
33. The rotation periods for the three types of partners subject to rotation follow:
- a. The lead partner and concurring partner are required to rotate off the audit after five years of service and then must complete a five-year time-off period before he or she can resume providing services to the client; and
 - b. All other audit partners subject to rotation are required to rotate off the audit after seven years of service and then must complete a two-year time-off period before he or she can resume providing services to the client.
34. The transition provisions for the rotation requirements are as follows:
- a. The rotation requirements applicable to the lead partner are effective for the first fiscal year beginning after May 6, 2003. Time previously served in the capacity of lead partner or concurring partner is included in determining the five-year service period. To illustrate, for a company with a December 31 year-end, the rules would be first effective for the year ending December 31, 2004. For a lead partner, if 2003 was that partner’s fifth, sixth or seventh year in that role, he or she would be able to complete the 2003 audit but must rotate off for the 2004 engagement.
 - b. The rotation requirements applicable to the concurring partner are effective for the first fiscal year beginning after May 6, 2004. Prior time served in the capacity of concurring partner or lead partner is included in determining the five-year service period.
 - c. For all other audit partners, the rules are effective for the fiscal year beginning after May 6, 2003. Time served prior to that first fiscal year does not count toward the seven-year service period.
 - d. For all partners (including lead and concurring partners) with foreign accounting firms who are subject to the rotation requirements, the rules are effective as of the first fiscal year that begins after May 6, 2003. Time served prior to that first fiscal year does not count toward the maximum service period.
35. The rotation rules apply to firms that audit investment companies. They view all companies within the same investment company complex as one client for rotation purposes. Audit partners may not satisfy the rotation requirements by rotating between investment companies in the same complex.

Interpretations and Implementation Considerations

- a. *Some partners, sometimes referred to as “client service partners,” do not have audit decision-making responsibility but instead manage the overall delivery of services to and relationships with clients. Usually these partners maintain regular contact with management and the audit committee, so they would be subject to the rotation requirements.*
- b. *Tax partners also do not have audit decision-making responsibility. Therefore, they would be subject to the rotation requirements only if they maintain regular contact with management and the audit committee.*

- c. *With respect to subsidiaries and the 20% test, we understand that the test should be applied as of the beginning of a year. Once a subsidiary meets this test, we understand that it should be considered significant for all future years unless it falls below the 20% threshold and is expected to stay below that level.*
- d. *The new five and seven-year service periods permit accounting firms to provide for transition without the “orientation” period counting toward the five-year service limit. In that regard, a partner can serve as an audit partner, other than the lead or concurring partner, on an engagement for two years and then serve as the lead partner for five years. However, no audit partner can ever serve in these roles for more than seven consecutive years. Therefore, if a partner served in the other role for three years, service as the lead partner would be limited to four years.*
- e. *Time spent in other roles (e.g., as a manager or as a partner on an insignificant subsidiary) does not count toward the five and seven-year service limits.*
- f. *The rules are not specific regarding the time-out periods required when a partner rotates off an engagement after serving less than the maximum time permitted. We understand that the intent is for a person to serve as a lead or concurring partner in no more than five years out of ten and in other roles for no more than seven years out of nine.*
- g. *We understand that in IPO situations, only the audited periods presented in the registration statement will count toward the service period limits, regardless of how long an individual has served a client.*
- h. *We understand that if audits of more than one year are performed concurrently (e.g., in an IPO situation), they will count as only one year in determining the service limits.*
- i. *We understand that if a company changes its year-end, the transition period will count as a full year in determining the service limits. In other words, a change in year-end will not permit a partner to exceed the service limits.*
- j. *In connection with a sale or a spin-off, a business that was part of another registrant may become a new separate registrant. We understand that if the new registrant’s management and audit committee are significantly different from those of the seller/spinnor, an audit partner’s service to the seller/spinnor would not count toward the service limits. This requires a subjective evaluation based on the facts and circumstances. Registrants and auditors should consider consulting with the SEC staff if the answer does not seem clear.*
- k. *With respect to transition, we understand that if, prior to the year in which the new rules take effect, the partner will have met the two-year time-out period under the old rules, the partner will be eligible to serve for five years. Otherwise the permitted service period under the new rules will be less than five years. For example:*
 - *Example 1 – A partner served as the lead partner for the seven calendar years ended December 31, 2001 and then rotated off the engagement. The issuer’s first year under the new rules is 2004. The partner will have been off the engagement for two years when the new rules take effect. The partner can serve as the lead partner for five years starting in 2004.*
 - *Example 2 – A partner served as the lead partner for the seven calendar years ended December 31, 2000 and then rotated off the engagement. The partner resumed serving as the lead partner in 2003. The issuer’s first year under the new rules is 2004. The partner will have been off the engagement for zero years when the new rules take effect. The partner can continue to serve as the lead partner for the four years 2004 – 2007.*
 - *Example 3 – A partner served as the lead partner for the two calendar years ended December 31, 2002 and then rotated off the engagement. The issuer’s first year under the new rules is 2004. The partner will have been off the engagement for one year when the new*

rules take effect. The partner will resume serving as the lead partner in 2005. The partner can serve as the lead partner for the three years 2005 – 2007.

Auditor Communications with Audit Committees

36. Section 204 of the Act requires the auditor to report, either orally or in writing, to the company's audit committee, on a timely basis:
 - a. All critical accounting policies and practices used by the company;
 - b. All alternative accounting treatments within GAAP related to material items that have been discussed with management, including the impact they would have on the company and the treatment preferred by the accounting firm (including recognition, measurement and disclosure considerations); and
 - c. Other material written communications between the accounting firm and management.
37. The new rules are substantially unchanged from the proposed rules. They largely mirror the requirements of the Act and codify current requirements under GAAS. However, the rules require these communications to occur before the company's annual report is filed with the SEC. It is anticipated that the communications will occur as frequently as quarterly or more often on a real-time basis.
38. The rules refer to the SEC's:
 - a. December 2001 cautionary advice regarding companies' disclosure in MD&A of those accounting policies that management believes are most critical to the preparation of the company's financial statements; and
 - b. May 2002 proposed rules that cover (a) accounting estimates a company makes in applying its accounting principles, and (b) the initial adoption by a company of an accounting policy that has a material impact on its financial presentation. (See section 18 below.)
39. Regarding critical accounting policies and practices, the SEC expects, at a minimum, that the discussion of critical accounting estimates and the selection of initial accounting policies will include the reasons why estimates or policies meeting the criteria in their December 2001 guidance are or are not considered critical and how current and anticipated future events impact those determinations. The communications should also include an assessment of management's disclosures along with any significant modifications proposed by the accountants that management did not make.
40. Regarding alternative accounting treatments:
 - a. The new rules require communication to audit committees of all alternative treatments within GAAP for policies and practices related to material items that have been discussed with management, including the ramifications of the use of such alternative treatments and disclosures and the treatment preferred by the accounting firm.
 - b. The rule is intended to cover recognition, measurement and disclosure considerations related to the accounting for specific transactions as well as general accounting policies.
 - c. Communications regarding specific transactions should identify, at a minimum, the underlying facts, financial statement accounts impacted, and applicability of existing corporate accounting policies to the transaction. Regardless of whether the accounting policy selected preexists or is new, the entire range of alternatives available under GAAP that were discussed by management and the accountants should be communicated along with the reasons for not selecting those alternatives.
 - d. Communications regarding general accounting policies should focus on the initial selection of and changes in significant accounting policies, as required by GAAS, and should include the impact of management's judgments and accounting estimates, as well as the accountant's judgments about the quality of the entity's accounting principles.
41. Examples of other written communications that the SEC expects would be considered material include:

- a. Management letter and other reports on observations and recommendations on internal controls;
 - b. Engagement letter;
 - c. Representation letter;
 - d. Independence letter; and
 - e. Material adjustments and reclassifications proposed and recorded and a schedule of unadjusted audit differences, if any.
42. These communications must be made prior to the filing of an auditor's report that is filed on or after May 6, 2003.

Interpretations and Implementation Considerations

- a. *The communication requirements apply only to "issuers." Thus, we understand that these communications are required only for audit reports filed after the date a company files an initial registration statement. After that date, if a company does not have an audit committee, the auditor must communicate these matters to the full board of directors.*
- b. *Certain audit committee communication requirements apply to reports reissued (or consents issued) on or after May 6, 2003. If an auditor reissues a report on or after May 6 (e.g., for inclusion in a registration statement or proxy statement or by consenting to the incorporation by reference of a report into a registration statement), the new Rule 2-07 communication requirements apply. The manner in which they must be applied is not clear, and the SEC staff is considering this matter further. However, the following is clear to the staff at this point:*
 - *The new communications requirements in Rule 2-07 do not apply retroactively. In other words, reissuing a report on or after May 6, 2003 does not require an auditor to communicate to the audit committee all of the matters he or she would have communicated if the new rule had been in place when the report was originally issued.*
 - *Nevertheless, there is at least one fact pattern where Rule 2-07 requires an auditor to discuss matters with the audit committee before reissuing a report that was originally issued before May 6 (or consenting to the incorporation by reference of such a report into a registration statement). That fact pattern is as follows. Assume that in performing the post-audit review procedures required by Section AU 711 of the Codification of Statements on Auditing Standards, an auditor identifies matters related to the audited financial statements that he or she would have communicated to the audit committee before he or she originally issued the report if those matters had existed or he or she had known about them at that time. The auditor would be required to communicate these matters to the audit committee before reissuing his or her report (or consenting to its use).*

Employment of Audit Team Members by a Client

43. Previous SEC rules would deem a firm to not be independent with respect to an audit client if a former partner or professional employee accepted employment with a client and that person had a continuing financial interest in the accounting firm or is in a position to influence the firm's operations or financial policies. The new rules retain this requirement and build on it by requiring a "cooling off" period between the time a person works on an audit and the time the person commences employment.
44. The new rules address some of the concerns raised in letters commenting on the proposed rules.
- a. While the proposed rules would have applied to the entire engagement team regardless of the hours incurred in servicing the client, the final rules exempt audit engagement team members, other than the lead and concurring partner, who provide less than ten hours of service during the annual audit period.
 - b. The rules also provide for an exemption for conflicts that are created through merger or acquisition.

- c. The rules provide for an additional exemption for emergency or unusual circumstances, provided the audit committee of the issuer determines that doing so is in the best interest of investors.
45. As adopted, the rules deem a firm to not be independent if a member of the audit engagement team is employed by the client in a financial reporting oversight role and that person was a member of the audit engagement team within one year prior to the commencement of audit procedures for the year that included employment with the issuer.
46. The term “financial reporting oversight role” refers to any individual who is in a position to influence the contents of the company’s financial statements and related information (e.g., MD&A) included in its SEC filings. People in such positions include but are not limited to members of the board of directors and executive and financial officers.
47. Audit procedures for an annual audit are deemed to have commenced for the current audit engagement period the day after the prior year’s periodic annual report is filed with the SEC, and are deemed to end on the day the current year’s annual report is filed with the SEC.
48. The practical effect of this is that an accounting firm must complete one annual audit subsequent to the audit in which an individual participated before the issuer can hire the individual in a financial reporting oversight role.
49. To illustrate the application of this rule, assume that Issuer A files its Form 10-Ks for the calendar years 2002, 2003, and 2004 on March 15, 2003, April 5, 2004, and March 10, 2005. The deemed audit engagement periods would be:
- For the audit of the 2003 financial statements, the audit engagement period would begin on March 16, 2003 and end on April 5, 2004; and
 - For the audit of the 2004 financial statements, the audit engagement period would begin on April 6, 2004 and end on March 10, 2005.
- If John Smith worked on the 2003 audit at any time during the 2003 engagement period, Smith cannot commence employment in a financial reporting role with Issuer A until after March 10, 2005. If Issuer A employs Smith before March 11, 2005, it would cause its accounting firm to lose its independence.
50. These rules are effective for employment that commences on or after May 6, 2003.

Interpretations and Implementation Considerations

- We expect the exception for emergency or unusual circumstances to be applied very rarely.*
- We understand that the rule that deems an audit engagement period to commence on the day after the prior year’s annual report is filed with the SEC is intended to serve as a bright line and reduce complexity. Therefore, the audit engagement period commences on this date, even if audit work on the current audit started before that date.*
- The cooling off period requirement applies only to “issuers.” Thus, we understand that no cooling off period is required for employment that commences before a company files an initial registration statement.*

Expanded Disclosure of Fees and Audit Committee Practices

51. The new rules with respect to expanded disclosure of fees paid to the auditor retain the basic provisions of the proposed rules. Regarding the principal accountant’s fees, the rules change both the categories of fees that must be disclosed in annual reports and proxy statements and the years covered by the disclosure. The categories of fees that must be disclosed are (a) audit fees, (b) audit-related fees, (c) tax fees, and (d) all other fees.
- The disclosures must show fees for each of the two most recent years, rather than just the most current fiscal year. Also, companies are required to describe, in qualitative terms, the types of services provided under the audit-related, tax and all other categories.
 - The final rules define audit services as those performed to comply with GAAS, even if not billed to an issuer as audit services. For example, tax services (e.g., tax accrual review) and accounting

- consultations, if provided in order to comply with GAAS, should be disclosed as audit services even if not billed to the issuer as such.
- c. In addition to services provided to conform to GAAS, the rules expand the types of fees that should be disclosed as audit services to include fees for services (1) provided by the accountant in connection with statutory and regulatory filings or engagements, and (2) related to comfort letters, statutory audits, attest services, consents, assistance with and review of documents filed with the SEC, and any other services that only the audit firm could reasonably provide.
 - d. Audit-related fees include services related to employee benefit plans, due diligence related to mergers and acquisitions, accounting consultations and audits in connection with acquisitions, internal control reviews, attest services that are not required by statute or regulation and consultation concerning proposed accounting and reporting standards.
 - e. The tax fees category should capture all services performed by professional staff in the audit firm's tax division except those services related to the audit as discussed above. Typically, it would include fees for tax compliance, planning and advice.
52. Regarding audit committee practices, the rules require disclosure, in detail, about the audit committee's policies and procedures for approving audit and non-audit services. Alternatively, companies can include a copy of those policies and procedures with the annual report and proxy statement.
- a. To the extent the audit committee has applied the de minimis exception, the issuer must disclose the percentage of total fees paid to the accountant where the de minimis exception was used. This information should be provided by category.
53. These new disclosures are required in the company's annual report and in the company's proxy statement. The annual report disclosures can be incorporated by reference to the proxy statement.
54. These rules are effective for periodic annual filings for fiscal years ending after December 15, 2003 and related proxy and information statements. The SEC encourages issuers to adopt the disclosure provisions earlier.

3. SEC Rule – Standards Relating to Listed Company Audit Committees (Release No. 33-8220)

- 1. The rules in this release implement Section 301 of the Act by directing the national securities exchanges and associations to prohibit the listing of the securities of an issuer that is not in compliance with the standards for audit committees as set forth in the Act.
- 2. The rules apply only to issuers whose securities are listed on a national securities exchange or association (e.g., the NYSE, AMEX and NASDAQ), all of which are referred to as "exchanges" in this guide. Interdealer quotation systems, such as the OTC Bulletin Board (OTCBB), the Pink Sheets and the Yellow Sheets, are not affected by the rules.
- 3. The rules apply to most listed securities, regardless of type, including equity securities, debt securities and derivative securities.
- 4. The rules apply to both domestic and foreign listed issuers (including small business issuers).
 - a. The rules also apply to investment companies, although they have been tailored to reflect certain unique aspects of investment companies' organizational structures and safeguards already provided by the Investment Company Act.
 - b. In the case of foreign listed issuers, several provisions have been made to address the special circumstances of particular foreign jurisdictions.
- 5. The rules apply to audit committees. Under Section 3(a)(58) of the Exchange Act, as added by Section 205 of the Act, the term "audit committee" is defined as:

- a. A committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and
 - b. If no such committee exists with respect to an issuer, the entire board of directors of the issuer.
6. As a background note, in 1998, the NYSE and NASD sponsored the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. In its 1999 report, the Blue Ribbon Committee recognized the importance of audit committees and issued ten recommendations to improve their effectiveness. In response, the securities exchanges revised their listing standards relating to audit committees and the SEC adopted new rules requiring disclosure relating to functioning, governance and independence of audit committees. The NYSE and NASD recently reviewed their corporate governance standards, including their audit committee rules, and have proposed changes to their rules to provide more demanding standards for audit committees. The Commission designed its rules to complement the expected changes to the exchanges' rules. In some cases, the proposed exchange rules are more stringent than the SEC's requirements discussed below.

Listing Standards

7. Under the rules, the issuer's audit committee must meet five standards for the issuer's securities to be listed.
8. First standard – Each member of the audit committee must be independent as defined by the Act.
 - a. To be independent, a member may not receive, either directly or indirectly, any compensation from the company other than in his or her capacity as a member of the board and its committees.
 - A member is barred from accepting any direct consulting, advisory or other compensatory fee from the issuer or an affiliate of the issuer, other than in the member's capacity as a board member. (Compensatory fees do not include the receipt of fixed payments for prior service under a retirement plan of the issuer.)
 - Indirect compensation includes compensation paid to spouses and children and to professional services organizations in which the member is a partner, member, or officer or holds a similar position. (The prohibition covers payments to accounting, consulting, legal, investment banking or financial advisory service firms.)
 - The rules do not preclude independence on the basis of other ordinary course of commercial business relationships between the company and an entity with which a director has a relationship.
 - The securities exchanges' standards of independence may prohibit additional relationships.
 - The rules apply only to current relationships with the audit committee member and related persons. The rules to be adopted by the exchanges may, however, include past relationships.
 - There is no de minimis exception with regard to the prohibition on compensatory payments.
 - b. To be independent, a member must also not be an affiliated person of the issuer or any of its subsidiaries.
 - Executive officers, directors who are also employees of an affiliate, general partners, and managing members of an affiliate are deemed to be affiliates.
 - The terms "affiliate" and "affiliated person" are consistent with the SEC's definitions of those terms under the securities laws. An "affiliated person" is "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified." "Control" is defined as "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."
 - The rules provide a safe harbor. A person who is not an executive officer or 10% shareholder of the issuer is deemed not to control the issuer. The ownership level specified in the safe

- harbor does not create a presumption that a person with a higher level of ownership is an affiliate.
9. Second standard – The audit committee must be directly responsible for the appointment, compensation, retention and oversight of the work of the independent auditor engaged for the purpose of preparing an audit report or performing other audit, review or attest services for the issuer, and the independent auditor must report directly to the audit committee.
 - a. The audit committee must have ultimate authority to retain the outside auditor, which includes the power not to retain (or to terminate) the outside auditor. In addition, the audit committee must have ultimate authority to approve all audit engagement fees and terms.
 - b. The SEC had initially proposed to exempt investment companies from the requirement that the audit committee be responsible for the selection of the independent auditor. As a result of the new auditor independence rules adopted in January, audit committees of investment companies are now required to pre-approve all audit, review and attest engagements performed by the independent auditor. In order to conform to the new auditor independence requirements, the final rules require the audit committee of an investment company to select the independent auditor. Under Section 32(a) of the Investment Company Act, the independent directors will be required to ratify the selection.
 10. Third standard – The audit committee must establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, including procedures for the confidential anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.
 - a. The rules do not mandate specific procedures that audit committees must establish. The SEC expects that each audit committee will develop procedures that work best consistent with its company’s individual circumstances.
 - b. These rules are often referred to as the “whistleblower” provisions.
 11. Fourth standard – The audit committee must have the authority to engage independent counsel and other advisors as it determines necessary to carry out its duties.
 12. Fifth standard – The issuer must provide appropriate funding for the audit committee to compensate the outside auditors and any lawyers and advisors it employs and to fund ordinary administrative expenses of the audit committee that are necessary in carrying out its duties.

Exceptions to the Independence Rules

13. The rules provide some general exceptions to the independence rules.
 - a. For companies coming to market for the first time, the rules require at least one independent member at the time of an issuer’s initial listing, a majority of independent members within 90 days, and a fully independent committee within one year.
 - b. The rules permit an audit committee member to sit on the boards of directors of both an issuer and an affiliate of the issuer if the committee member otherwise meets the independence requirements for each entity.
 - c. If a member of an audit committee ceases to be independent for reasons outside the member’s control, the rules permit the member to remain on the audit committee until the earlier of the issuer’s next annual shareholders meeting or one year from the occurrence of the event that caused the member’s independence to be impaired.
14. The rules also provide foreign private issuers with a number of exceptions to the independence rules to accommodate the different legal requirements of some foreign jurisdictions.
 - a. A foreign private issuer’s audit committee may include an employee as a member, as long as he or she (i) is not an executive officer of the company and (ii) is elected or named to the board of

- directors or audit committee pursuant to the issuer's governing law or documents, an employee collective bargaining agreement, or other home country legal or listing requirements.
- b. A foreign private issuer's audit committee may include a member who is an affiliate of the company or a representative of an affiliate if (i) the member has only observer status on the committee (i.e., the member has no voting power) and (ii) neither the member nor the affiliate is an executive officer of the company.
 - c. A foreign private issuer's audit committee may include a member that is a representative of a foreign government that is an affiliate of the foreign private issuer if the member is not an executive officer of the company.
 - d. The independence rules also accommodate foreign private issuers that operate under a dual holding company structure. The rules permit a listed issuer to designate one audit committee for both companies so long as each member of the audit committee is a member of the board of directors of at least one of the holding companies.
 - e. In addition to the exceptions noted above, the rules allow the Commission to exempt an audit committee member from the independence requirements as it determines appropriate in light of the circumstances.

General Exemptions

15. A number of general exemptions from the rules have been provided.
 - a. If an issuer has a class of securities that is listed on an exchange and subject to its listing requirements, the listing of additional classes of securities on the same exchange or another exchange is exempt from the rules.
 - b. The listing of classes of non-equity securities of a direct or indirect consolidated subsidiary of a listed issuer or an at least 50% beneficially owned subsidiary is exempt from the rules.
 - c. Subject to certain conditions, the listing of securities of a foreign private issuer is exempt from the rules if the foreign private issuer has a board of auditors (or similar body) or has statutory auditors that are generally required, to the extent permitted by law, to meet the standards contained in the rules.
 - The board or body or statutory auditors must be (i) separate from the board of directors or (ii) composed of one or members of the board of directors and one or more members that are not also members of the board of directors; and
 - The board or body or statutory auditors must not have been elected by management and must not include an executive officer of the issuer.
 - d. The listing of a securities futures product or a standardized option is not subject to the rules.
 - e. Asset-backed issuers, unit investment trusts, foreign governments, and issuers organized as passive trusts or other unincorporated associations that do not have a board of directors are exempt from the rules.
16. The instructions to the rules address potential conflicts between the rules and the home country laws of foreign private issuers. They clarify that the rules do not conflict with nor affect the application of any requirement or ability under a listed issuer's governing law or documents or home country legal or listing provisions that requires or permits shareholders to vote on, approve or ratify any of the audit committee requirements. To the extent permitted by the issuer's home country law, the audit committee should be responsible for making recommendations or nominations regarding such matters.

Disclosure Requirements

17. The new rules also require certain disclosures:
 - a. New Item 401(i) of Regulation S-K (as well as the companion rules adopted for small business issuers) requires an issuer to include or incorporate by reference in its annual report the names of

each audit committee member or, if the issuer does not have a separate audit committee, state that the entire board of directors is acting as the audit committee.

- This information was previously required only in proxy or information statements where action is to be taken with respect to the election of directors.
- b. In addition, an issuer that relies on (1) certain of the exceptions to the independence standards described above, including those provided for foreign private issuers or (2) the general exemption from the audit committee requirements provided for a foreign private issuer that has a board of auditors or statutory auditors must disclose this fact in its annual report (either by inclusion or incorporation by reference) and its proxy or information statement for shareholders meetings at which directors are elected.
- The disclosure must include the issuer's assessment of whether, and if so, how, such reliance would materially adversely affect the ability of the audit committee to act independently and to satisfy the other requirements of the rules.

Enforcement

18. The rules do not establish specific mechanisms for securities exchanges to ensure that issuers comply with the listing standards on an ongoing basis. They direct the securities exchanges to require a listed issuer to notify the applicable securities exchange promptly after an executive officer of the issuer becomes aware of any material noncompliance with the requirements.
19. The rules require the securities exchanges to provide appropriate procedures for an issuer to have an opportunity to cure any defects that would be the basis for delisting the issuer's securities as a result of its failure to meet the rules before imposition of a delisting.

Updates of Other Rules

20. The rules update the existing disclosure requirements in proxy and information statements regarding the independence of audit committee members to reflect the new rules to be adopted by the exchanges. The rules clarify that if the registrant does not have a separate audit committee, the disclosure must be provided for all members of its board of directors.
21. The rules also update the Commission's rules requiring audit committee financial expert disclosures, which were adopted in January.
- a. As a result, an issuer will evaluate the independence of its audit committee financial experts using the enhanced independence standards that will be reflected in the rules to be adopted by the exchange on which its securities are listed.
 - b. If an issuer is not listed, it will make the evaluation using the standards of an exchange of its choice.
 - c. In addition, a foreign private issuer will be required to evaluate and disclose whether its audit committee financial expert is independent. It will do so using the same approach and standards as a domestic issuer.

Effective Dates

22. The exchanges must adopt revised listing standards as follows:
- a. They must submit proposed rules or rule amendments that comply with the requirements no later than July 15, 2003.
 - b. Final rules or amendments must be approved by the Commission no later than December 31, 2003.
23. Issuers must comply as follows:

- a. Issuers other than foreign private issuers and small business issuers must be in compliance with the new listing rules by the earlier of (i) their first annual shareholders meeting after January 15, 2004, or (ii) October 31, 2004.
- b. Foreign private issuers and small business issuers must be in compliance with the new listing rules by July 31, 2005.

4. SEC Rule – Certification of Disclosure in Companies’ Quarterly and Annual Reports (Release No. 33-8124)

1. Rule adopted as required by Section 302 of the Sarbanes-Oxley Act. In accordance with its rulemaking regarding Section 404 of the Act, the SEC has proposed that certain provisions discussed below be amended.
2. Applies to all public companies, including foreign private issuers, small business issuers and registered investment companies.
3. Certification applies to annual reports on Forms 10-K, 10-KSB, 20-F and 40-F; quarterly reports on Forms 10-Q and 10-QSB; and to amendments to, and transition reports on, any of the foregoing reports. Current reports (e.g., Form 6-K and 8-K) are not covered. The SEC is soliciting comments on whether other documents (e.g., Form 10 and 10-SB and definitive proxy and information statements) should be certified by an issuer’s senior officers.
4. While not directly addressed by the Sarbanes-Oxley Act, the rule requires companies to maintain procedures to collect, process and disclose, within the time periods specified by the SEC, information required to be disclosed in the Exchange Act reports. Within 90 days of the filing date of any quarterly or annual report, and under the supervision of the principal executive and financial officers, issuers are required to conduct an evaluation of the effectiveness of the design and operation of their “disclosure controls and procedures” (see definition below). (As discussed in section 12, this requirement was amended. For reports due on or after August 14, 2003, the evaluation must be made as of the end of each fiscal quarter.) As indicated below, the CEO and CFO must certify that they have reviewed the results of the company’s evaluation of procedures.
5. Specifically, the rules require the CEO and CFO to certify in each annual or quarterly report that:
 - a. He or she has reviewed the report;
 - b. Based on his or her knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by the report (*note that this statement mirrors the existing statutory disclosure standards for “material” accuracy and completeness of information in reports*);
 - c. Based on his or her knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition, results of operations and cash flows of the issuer as of, and for, the periods presented in the report (*note that this financial disclosure includes financial statements (including footnotes), selected financial data, MD&A, and other financial information in a report; note also that this certification is not limited to a representation that the financial statements and other financial information have been presented in accordance with GAAP; rather it is intended to provide assurances that the financial information disclosed in a report, viewed in its entirety, meets a standard of overall material accuracy and completeness that is broader than financial reporting requirements under GAAP*);
 - d. He or she and the other certifying officers:

- Are responsible for establishing and maintaining “disclosure controls and procedures” (a newly-defined term reflecting the concept of controls and procedures related to disclosure embodied in Section 302(a)(f) of the Act) for the issuer;
 - 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 reports are being prepared;
 - Have evaluated the effectiveness of the issuer’s disclosure controls and procedures as of a date within 90 days prior to the filing date of the report (as discussed in section 12, this requirement was amended; for reports due on or after August 14, 2003, the evaluation must be made as of the end of each fiscal quarter); and
 - 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;
- e. He or she and the other certifying officers have disclosed to the issuer’s auditors and the audit committee of the board of directors:
- All significant deficiencies in the design or operation of internal controls which could adversely affect the issuer’s ability to record, process, summarize and report financial data and have identified for the issuer’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 issuer’s internal controls; and
- f. He or she and the other certifying officers 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. (As discussed in section 12, this requirement was amended. For reports due on or after August 14, 2003, the disclosure must cover changes in internal control that took place during the most recent fiscal quarter.)
6. The certifications under a, b and c above first applied to quarterly and annual reports filed after August 29, 2002. Certifications under d, e and f above first applied to quarterly and annual reports filed for periods ended after August 29, 2002.
7. “Disclosure controls and procedures” are defined as controls and other procedures of an issuer that are designed to ensure that information required to be disclosed by the issuer 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” include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in its Exchange Act reports is accumulated and communicated to the issuer’s management, including its principal executive and financial officers, as appropriate to allow timely decisions regarding required disclosure.
8. The rules do not require any particular procedures for conducting the required review and evaluation of disclosure controls and procedures. The SEC does recommend that an issuer create a committee with responsibility for considering the materiality of information and determining disclosure obligations on a timely basis. The suggested composition of the committee includes the principal accounting officer (or 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 and others as deemed appropriate.
9. The certification must be in the exact form set forth in the amendments to the affected reports.
10. The certifications were required to follow immediately after the signature sections of the applicable reports. (Rules that relocated the certifications and require that they be filed as exhibits have been

adopted. See section 12 below.) The certifications do not alter the current signature requirements of quarterly and annual reports.

11. Legal counsel generally do not recommend that companies attempt to combine the certifications of Sections 302 and 906 (see section 1 above), as the wording of the two certifications is not the same and they are possibly subject to different standards of review.

5. SEC Rule – Improper Influence on Conduct of Audits (Release No. 34-47890)

1. Section 303 of the Act makes it unlawful for officers and directors of an issuer, and persons under their direction, to improperly influence the auditor of the issuer's financial statements.
2. To implement Section 303, the SEC adopted new Exchange Act Rule 13b2-2(b) and (c). The rule prohibits an officer or director of an issuer, or any other person acting under the direction thereof, from directly or indirectly taking any action to coerce, manipulate, mislead or fraudulently influence any independent public or certified public accountant engaged in the performance of an audit or review of the financial statements of that issuer if that person knew or should have known that such action, if successful, could result in rendering such financial statements materially misleading.
3. Much of the misconduct addressed by the new rule generally would be subject to other provisions of the securities laws and the Commission's regulations.
4. The term "officer" includes the company "president, vice president, secretary, treasurer or principal financial officer, comptroller or principal accounting officer, and any person routinely performing corresponding functions." The term also includes the company's chief executive officer and other executive officers.
5. "Any other person acting under the direction thereof" encompasses a broader category of people than those under the supervision or control of an officer or director. Such persons might include:
 - a. Employees, customers, vendors, or creditors who, under the direction of the officer or director, provide false or misleading confirmations or other false or misleading information to auditors, or who enter into "side agreements that enable an issuer to mislead its auditor" and
 - b. Partners or employees of an accounting firm, such as consultants or forensic accounting specialists retained by counsel for the issuer, and attorneys, securities professionals, or other advisors who, for example, pressure an auditor to limit the scope of the audit, to issue an unqualified report on the financial statements when such report would be unwarranted, to not object to an inappropriate accounting treatment, or not to withdraw a report on the company's financial statements.
6. "Engaged in the performance of an audit" includes the professional engagement period and any other time the auditor is called upon to make decisions or judgments regarding the issuer's financial statements. This includes the period when negotiations for retention of the auditor take place. It also includes the period subsequent to the professional engagement period when the auditor is considering whether to issue a consent to the use of a prior year's audit report.
7. Under new Rule 13b2-2(b)(2), actions that improperly influence an auditor include, but are not limited to, actions taken to coerce, manipulate, mislead, or fraudulently influence an auditor:
 - a. To issue or reissue a report on an issuer's financial statements that is not warranted in the circumstances due to violation of generally accepted accounting principles, generally accepted auditing standards, or other professional standards;
 - b. Not to perform an audit, review or other procedures required by generally accepted auditing standards or other professional standards;
 - c. Not to withdraw an issued report; or
 - d. Not to communicate matters to an issuer's audit committee.

8. In the discussion in the release, the Commission lists types of conduct that it believes might constitute improper influence. They include, but are not limited to, directly or indirectly:
 - a. Offering or paying bribes or other financial incentives, including offering future employment or contracts for non-audit services;
 - b. Providing an auditor with inaccurate or misleading legal analysis;
 - c. Threatening to cancel or canceling existing non-audit or audit engagements if the auditor objects to the issuer's accounting;
 - d. Seeking to have a partner removed from the audit engagement because the partner objects to the issuer's accounting;
 - e. Blackmailing; and
 - f. Making physical threats.
9. The discussion in the release also states that the Commission does not intend to hold any party accountable for honest and reasonable mistakes or to sanction those who actively debate accounting or auditing issues.
10. The rules were effective June 27, 2003.

Implementation Considerations

- a. *If an issuer identifies violations or potential violations of this rule, it should also consider the implications under other provisions of the securities laws and other Commission regulations. In that regard, under recently adopted Commission rules:*
 - *An attorney appearing and practicing before the Commission is required to report material violations of laws "up the ladder" within an issuer.*
 - *Companies that have adopted a code of ethics will need to consider what actions they must take if the conduct violates that code.*
- b. *In addition, auditors will need to consider their responsibilities under Section 10A of the Exchange Act, which requires them to report likely illegal acts to management and assure that the issuer's audit committee is informed of the act.*

**6. SEC Rule – Insider Trades During Pension Fund Blackout Periods
(Release No. 34-47225 and No. 33-8216)**

1. The SEC adopted new Regulation Blackout Trading Restriction (BTR) to clarify the rules contained in Section 306(a) of the Act. Section 306(a) of the Act applies to public companies that sponsor individual account plans through which participants invest in company equity securities. During "blackout" periods, investors cannot transfer balances between investment options.
2. Section 306(a) makes it unlawful for a director or executive officer of an issuer of any equity security, directly or indirectly, to purchase, sell or otherwise acquire or transfer any equity security of the issuer during a pension plan blackout period with respect to the equity security, if the director or executive officer "acquires such equity security in connection with his or her service or employment as a director or executive officer." This covers both equity securities that that were acquired before (that may be disposed of during the blackout period), or are acquired during, a pension blackout period.
3. Regulation BTR clarifies what a blackout period is, to whom the restrictions would apply, and what types of transactions and securities are subject to trading restrictions. It also requires companies to notify directors and officers of an impending blackout period and to notify the SEC by filing the notice on a Form 8-K. The new Regulation BTR was adopted substantially as proposed, with a few minor changes.
4. New Regulation BTR is organized as follows:
 - a. Rule 100 defines the terms used in Section 306(a) of the Act and Regulation BTR;

- b. Rule 101 clarifies the operation of the Section 306(a) trading prohibition and lists transactions that are exempt from the prohibition;
 - c. Rule 102 describes the exceptions to the definition of “blackout period;”
 - d. Rule 103 clarifies the operation of the private remedy for a violation of the Section 306(a) trading prohibition, including a method for calculating recoverable profits; and
 - e. Rule 104 sets forth the requirements for the notice that issuers must provide to officers and directors and to the SEC in connection with the blackout period.
5. Regulation BTR applies to directors and executive officers of domestic issuers, foreign private issuers, small business issuers and, in rare instances, registered investment companies.
6. Persons subject to the trading prohibition include:
 - a. Except in the case of foreign private issuers, directors and executive officers as those terms are defined in the Exchange Act (Section 3(a)(7) for directors and Rule 16a-1(f) for officers), until such time as they no longer function in such roles; and
 - b. For foreign private issuers, “director” means a director who is a management employee of the issuer, and “executive officer” means the principal executive officer, principal financial officer and the principal accounting officer.
7. The trading restrictions apply to all equity securities of the company, including derivative securities (e.g., phantom stock) and, in the case of foreign private issuers, depository shares evidenced by American Depository Receipts.
8. Rule 100(a) defines “acquired in connection with service or employment” to include securities acquired by a director or officer under the following conditions:
 - a. During service as a director or officer, securities acquired under a compensatory plan, contract, authorization or arrangement, including, but not limited to, plans relating to options, warrants or rights, pension, retirement or deferred compensation or bonus, incentive or profit-sharing, including those plans and arrangements with a parent, subsidiary or affiliate of the company;
 - b. During service as a director or officer, securities acquired as a result of any transactions or business relationships as described in Item 404 of Regulation S-K;
 - c. During service as a director, securities acquired to satisfy the requirement that the individual be a security holder (so-called “directors’ qualifying shares”) or to satisfy minimum ownership requirements;
 - d. Prior to becoming, or while a director or executive officer, securities acquired as a direct inducement to service or employment as a director or officer; and
 - e. Prior to becoming, or while a director or executive officer, securities acquired as a result of a business combination, if directly related to service as a director or officer.
9. Rule 100(b) of Regulation BTR defines a blackout period as any period during which a company or any fiduciary of the plan temporarily suspends the ability of at least 50% of the participants or beneficiaries located in the United States under the company’s individual account plans to purchase or sell company equity securities held in those plans for more than three consecutive business days.
10. In the case of a foreign private issuer, a blackout period occurs when the conditions above are met and either (1) the number of plan participants located in the United States and subject to the temporary suspension exceeds 15% of the foreign private issuer’s total worldwide employees, or (2) the number of participants located in the United States and subject to the temporary suspension exceeds 50,000.
11. The individual account plans to consider in determining whether a blackout period has occurred are those that permit investors located in the United States to acquire or hold equity securities of the issuer, even if those plans do not contain equity securities of the issuer at the time of the temporary trading suspension.
12. For purposes of determining the number of participants and beneficiaries in an individual account plan located in the United States, an issuer may use plan census data as of any date within 12 months

- before the beginning date of the blackout period. Where there has been a significant change in plan participation since the date selected, an issuer must use census data as of the most recent date that reflects the change.
13. Rule 102 lists two situations that are not considered to be a blackout:
 - a. Regularly scheduled blackout periods that are incorporated into a plan and disclosed on a timely basis to employees before they become participants. Participants must be notified either before or within 30 days following their enrollment or within 30 days following the adoption of a plan amendment; and
 - b. Suspensions imposed due to mergers, acquisitions or divestitures.
 14. The rules address three transitional situations:
 - a. Securities acquired under a compensatory plan while an individual is an employee of the issuer but before he or she becomes an executive officer or director are not subject to the trading restriction;
 - b. Securities acquired by a director or officer before an entity becomes an issuer are subject to the trading prohibition; and
 - c. Securities acquired by a director or officer before the effective date of Section 306(a), (January 26, 2003), are subject to the trading restriction.
 15. Rule 101(b) provides that if a director or executive officer sells equity securities of the issuer during a blackout period, he or she will have to establish that those shares were not acquired in connection with his or her employment, by specifically identifying the origin of the shares in question.
 16. Rule 101(c) provides that the following transactions are exempt from the trading restrictions:
 - a. Securities acquired through dividend or interest reinvestment plans;
 - b. Purchases or sales made pursuant to a trading arrangement that satisfies the Exchange Act affirmative defense conditions;
 - c. Purchases or sales, other than discretionary transactions, made pursuant to certain “tax-conditioned” plans, including, if certain conditions are met, plans of foreign private issuers;
 - d. Increases or decreases in shares as a result of stock splits or dividends;
 - e. Compensatory grants and awards pursuant to plans that provide for the grants and awards to occur automatically;
 - f. Settlement of a derivative security, if written or acquired before a blackout period and while unaware of a pending blackout period, where the settlement date is not in the control of the director or officer;
 - g. Acquisitions or dispositions involving a bona fide gift or transfer by will;
 - h. Acquisitions or dispositions pursuant to a domestic relations order;
 - i. Sales required by law; and
 - j. Acquisitions or dispositions in connection with a business combination that is required by law.
 17. Under Rule 104, companies will be required to notify directors and executive officers of impending blackout periods no later than 5 business days after the issuer receives notice from the plan administrator or, if no such notice is received, 15 days before the actual or expected blackout period. The notice must be in writing and must provide:
 - a. Reasons for the blackout;
 - b. A description of the plan transactions to be suspended;
 - c. The class of securities subject to the suspension;
 - d. The expected beginning and ending dates (or calendar weeks) of the blackout period; and
 - e. The person to contact with questions.
 18. An exception to the notification requirement is granted in any case where an unforeseeable event, beyond the issuer’s control, prevents such notice.

19. If an issuer provides only the calendar weeks of the blackout period in the notice to directors and officers, the notice must also contain information about how they may obtain, without charge, the actual beginning and ending dates. This information must be made available for two years after the blackout period.
20. An issuer must provide directors and executive officers with an updated notice if there is a change from the original notice in the beginning or ending dates of the blackout period.
21. Companies, including registered investment companies, will also be required to notify the SEC of a blackout period by filing a Form 8-K, which would include under new Item 11 the information provided to the directors and executive officers. The Form 8-K must be filed on the same date the notice is transmitted to directors and executive officers. In Release No. 33-8216, the SEC stated that it has not made the necessary programming changes to the EDGAR filing system to permit it to receive filings under new Item 11. The Commission instructed registrants to temporarily continue to provide the information required by Item 11 of Form 8-K under Item 5 of Form 10-Q or 10-QSB in the first quarterly report filed after a blackout period commences. Registrants should include a statement under Item 5 that the information is being provided pursuant to Item 11 of Form 8-K.
22. Foreign private issuers must furnish notice of blackout periods that occurred during the year to the SEC in their annual reports on Form 20-F or 40-F. They are encouraged by the SEC to make the required disclosure sooner under cover of Form 6-K.
23. Persons who violate the trading prohibitions are subject to possible SEC enforcement actions and related penalties. In addition, under Rule 103, the company or a security holder on its behalf may bring action to recover any profits from prohibited trades.
24. To provide guidance to the courts in determining recoverable profits, Rule 103(c) provides that:
 - a. In the case of listed securities, profit is to be measured as the difference between the amount paid or received for the security on the date of the transaction during the blackout period and the average market price of the security calculated over the first three trading days after the ending date of the blackout period; and
 - b. For unlisted securities, profits are to be calculated in a manner that identifies the amount of gain realized or loss avoided.
25. Section 306 of the Act was effective on January 26, 2003, and Regulation BTR applies to blackout periods commencing on or after that date. For blackouts commencing any time during the first 30 days after the effective date (i.e., between January 26, 2003 and February 25, 2003), issuers were required to furnish notices to directors and executive officers as soon as reasonably practical.
26. The required notice to the SEC on Form 8-K became effective on March 29, 2003. In the interim, an issuer could provide the required information to the SEC by disclosing it in the first quarterly report filed after commencement of the blackout period.

7. SEC Rule – Implementation of Standards of Professional Conduct for Attorneys (Release No. 33-8185)

1. Section 307 of the Act requires the SEC to prescribe minimum standards of professional conduct for attorneys appearing and practicing before the SEC in any way in the representation of issuers, including rules imposing an “up the ladder” reporting requirement. The SEC created rules that are codified in Part 205 of the Code of Federal Regulations, “Standards of Professional Conduct for Attorneys Appearing and Practicing Before the Commission in the Representation of the Issuer.” The rules are intended to protect investors and increase their confidence in public companies by ensuring that attorneys who work for those companies respond appropriately to evidence of material misconduct.

2. The rules have been significantly modified from what was originally proposed in November 2002 in response to the many comments and suggestions received:
 - a. The triggering standard for reporting evidence of a material violation has been raised;
 - b. The documentation requirements imposed upon attorneys and issuers under the proposed rule have been eliminated;
 - c. The proposed “noisy withdrawal” requirement has been delayed for further consideration; and
 - d. A “safe harbor” provision has been added to protect attorneys, law firms, issuers and officers and directors of issuers.
3. In addition to up the ladder reporting, the Commission had proposed to require attorneys to report violations outside the company in those rare cases where they have not received an appropriate response and they believe a violation is occurring. Under the proposed “reporting out” requirements, attorneys would be required to make a “noisy withdrawal” through which they would disaffirm a document or filing involving a violation. The Commission has deferred rulemaking with respect to reporting out requirements. The Commission continues to seek comments on and consider its previous proposal. In addition, the Commission has proposed an alternative approach under which the issuer, instead of the attorney, would be required to disclose its counsel’s withdrawal to the Commission. All issuers, including foreign private issuers and registered investment companies, would be required to report the attorney’s withdrawal within two business days. Domestic issuers, including investment companies, would file the notice on Form 8-K. Foreign issuers would file the notice on Form 20-F or 40-F. This proposal is outlined in Release 33-8186. Comments were due by April 7, 2003
4. The definitions applicable to the rules are contained in Section 205.2. The primary provisions of the rules are contained in Sections 205.3(b), (c) and (d), and Sections 205.6 and 205.7.
5. Section 205.2 includes the following definitions of terms that are used in the rules:
 - a. *Appearing and practicing before the Commission means:*
 - Transacting any business with the Commission, including communications in any form;
 - Representing an issuer in a Commission administrative proceeding or in connection with any Commission investigation, inquiry, information request or subpoena;
 - Providing advice regarding United States securities laws or the Commission’s rules regarding any document that the attorney has notice will be filed with the Commission (the proposed rules did not require that the attorney have notice that a document would be filed with the Commission); or
 - Advising an issuer as to whether information is required to be filed the Commission.

Appearing and practicing before the Commission does not include an attorney who:

 - Does not have an attorney-client relationship with the client for whom the services described above are performed; or
 - Is a non-appearing foreign attorney.
 - b. *Appropriate response* means a response to an attorney regarding his or her reported evidence of a material violation as a result of which the attorney reasonably believes:
 - That no material violation has occurred, is ongoing, or is about to occur;
 - That the issuer has adopted appropriate remedial measures;
 - That the issuer, with the consent of the issuer’s board of directors or qualified legal compliance committee, has retained an attorney to review the reported evidence of a material violation and either:
 - 1) Has substantially implemented any remedial recommendations made by such attorney; or
 - 2) Has been advised that such attorney may assert a colorable defense (i.e., a defense that meets the standards governing the positions that an attorney appropriately may take before the tribunal before whom he or she is practicing).

- c. *Breach of fiduciary duty* refers to any breach of fiduciary or similar duty to the issuer recognized under an applicable federal or state statute or at common law, including but not limited to misfeasance, nonfeasance, abdication of duty, abuse of trust and approval of unlawful transactions.
 - d. *Evidence of a material violation* means credible evidence, based upon which it would be unreasonable, under the circumstances, for a prudent and competent attorney not to conclude that it is reasonably likely that a material violation has occurred, is ongoing, or is about to occur.
 - e. *Material violation* means a material violation of an applicable United States federal or state securities law, a material breach of fiduciary duty arising under United States federal or state law, or a similar material violation of any United States federal or state law.
 - f. *Qualified Legal Compliance Committee (QLCC)* means a committee of an issuer that:
 - Consists of at least one member of the issuer’s audit committee (or equivalent committee of independent directors) and two or more members of the issuer’s board of directors who are not employed by the issuer (the issuer’s audit committee may also be designated as the QLCC);
 - Has adopted written procedures for the confidential receipt, retention and consideration of any report of evidence of a material violation; and
 - Has been given the authority and responsibility by the board of directors to carry out the required procedures with respect to receipt, retention and consideration of any report of evidence of a material violation that the Chief Legal Officer (CLO) would otherwise be required to carry out.
6. Section 205.3(b) prescribes the duty of an attorney to report evidence that a “material violation” has occurred, is occurring, or is about to occur.
- a. The attorney is to first make this report to the company’s CLO or to the company’s CLO and CEO.
 - b. The company’s CLO is then required to conduct a reasonable inquiry of the attorney’s report.
 - c. A CLO who concludes that there has been no material violation must notify the reporting attorney of this conclusion.
 - d. A CLO who concludes that a material violation has occurred, is occurring or is about to occur, must take reasonable steps to ensure that the company adopts appropriate remedial measures and/or sanctions, including appropriate disclosures. The CLO must advise the reporting attorney of the steps taken.
 - e. The CLO is also required to report “up the ladder” within the company what remedial measures have been adopted or sanctions imposed.
 - f. An attorney retained by the CLO to investigate a report of evidence of a material violation is considered to be practicing before the Commission, but is not obligated to report evidence of a material violation under this rule if:
 - The attorney reports the results of his or her investigation to the CLO, and the CLO reports the results “up the ladder” within the company; or
 - The attorney was retained by the CLO to assert a colorable defense on behalf of the issuer in any litigation relating to the reported evidence of a material violation, and the CLO reports on the progress and outcome of the proceeding “up the ladder” within the company.
 - g. An attorney retained directly by the QLCC to investigate evidence of a material violation would report the results of his or her investigation directly to the QLCC, and not to the CLO.
 - h. A reporting attorney who receives an appropriate response within a reasonable period of time has satisfied his or her obligations under the rule.
 - i. If the reporting attorney does not receive an appropriate response within a reasonable time, he or she must report the evidence of a material violation to the company’s audit committee or (if no

- audit committee) to another committee of independent directors or (if no such other committee) to the full board.
- j. If the reporting attorney believes it would be futile to first report to the CLO and CEO, he or she may report directly to the company's audit committee, other committee or full board.
 - k. A reporting attorney who has reported the matter all the way "up the ladder" within the company and reasonably believes that the company has not responded appropriately must explain his or her reasons to the CLO, the CEO, and the directors to whom the attorney reported the evidence of a material violation.
7. Section 205.3(d)(1) grants an attorney the authority to use any documentation related to his or her report of a material violation, including an issuer's response, in a proceeding in which the attorney's compliance with these rules is an issue.
 8. Under Section 205.3(d)(2), an attorney may reveal to the SEC, without the issuer's consent, confidential information related to the representation, to the extent he or she believes necessary, to:
 - a. Prevent the issuer from committing a material violation that is likely to cause substantial injury to the financial interest or property of the issuer or investors;
 - b. Prevent the issuer from committing fraud or perjury in an SEC investigation; and
 - c. Rectify the consequences of a material violation that caused substantial injury to the financial interest or property of the issuer or investors.
 9. Section 205.3(c) provides an alternative system for reporting evidence of material violations to the QLCC.
 - a. Companies may, but are not required to, establish a QLCC for the purpose of investigating reports of material violations made by attorneys.
 - b. The QLCC must have the authority and responsibility to:
 - Conduct any necessary inquiry into the reported evidence;
 - Recommend that the company adopt appropriate remedial measures to prevent an ongoing, or alleviate a past, material violation; and
 - Take all other appropriate action including notifying the SEC of the material violation and disaffirming any tainted document submitted to the SEC.
 - c. A reporting attorney would satisfy his or her reporting obligation by reporting evidence of a material violation to the QLCC.
 - d. A CLO who receives a report of a material violation may refer the report to a QLCC in lieu of conducting his or her own inquiry.
 10. Section 205.6 describes the manner in which the SEC will address violations of the rule.
 - a. Violation of the rule by any attorney appearing and practicing before the SEC in representation of the issuer will subject the attorney to the civil penalties and remedies for a violation of the federal securities laws available to the SEC in an action brought by the SEC.
 - b. An attorney who violates a provision of Part 205 will have engaged in improper professional conduct and may also be subject to administrative disciplinary proceedings that can result in a censure, or a suspension or bar from practicing before the SEC.
 - c. An attorney practicing outside the United States is not required to comply with these rules to the extent compliance would be prohibited by applicable foreign law.
 11. Section 205.7 has been added as a safe harbor. It provides that nothing in the rules creates a private right of action against an attorney, law firm, or issuer based upon compliance or noncompliance with the rules.
 12. These rules are effective August 5, 2003. The Commission adopted a deferred effective date in order to provide time to change them if necessary in connection with whatever "noisy withdrawal" provisions it decides to adopt.

8. SEC Rule – Disclosure in Management’s Discussion and Analysis About Off-Balance Sheet Arrangements and Aggregate Contractual Obligations (Release No. 33-8182)

1. These new rules implement Section 401(a) of the Act.
2. Section 401(a) requires the SEC to adopt rules requiring annual and quarterly financial reports filed with the SEC to disclose “all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities or other persons, that may have a material current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources, or significant components of revenues and expenses.”
3. The rules require a company to provide:
 - a. A comprehensive explanation of its off-balance sheet arrangements in a designated section of MD&A; and
 - b. An overview of its aggregate contractual obligations in tabular format (encouraged but not required for small business issuers).
4. The final rules do not require companies to provide disclosures about contingent liabilities and commitments, as was proposed.
5. Regulation S-K Item 303, *Management’s Discussion and Analysis of Financial Condition*, and the companion requirements in Regulation S-B and Forms 20-F and 40-F have been amended to incorporate the new disclosure requirements.
6. The rules codify much of the guidance the SEC provided in January 2002 in FR-61, *Commission Statement about Management’s Discussion and Analysis of Financial Condition and Results of Operations*.

Off-Balance Sheet Arrangements

7. As proposed, a company would have had to disclose an off-balance sheet arrangement if there was more than a remote possibility that the arrangement could materially affect the company. The final rules follow the existing MD&A disclosure threshold, requiring a company to disclose an off-balance sheet arrangement only if it is reasonably likely that the arrangement will materially affect the company.
8. The final rules define “off-balance sheet arrangements” more narrowly than was proposed, and employ concepts in existing U.S. accounting literature. Foreign private issuers who do not prepare their primary financial statements in accordance with U.S. GAAP must nevertheless look to the U.S. GAAP references in the definitions to identify the types of arrangements they need to discuss. However, a foreign private issuer’s MD&A should continue to focus on its primary financial statements.
9. The definition includes any contractual arrangement to which an unconsolidated entity is a party, under which the company has:
 - a. Any obligation under certain guarantee contracts, whether or not recorded as liabilities (consistent with the scope of FASB Interpretation No. (FIN) 45, as discussed below);
 - b. A retained or contingent interest in assets transferred to an unconsolidated entity or similar arrangement that serves as credit, liquidity or market risk support to that entity for such assets;
 - c. Any obligation under certain derivative instruments that are classified as equity; or
 - d. Any obligation under a material variable interest held by the company in an unconsolidated entity that provides financing, liquidity, market risk or credit risk support to the company, or engages in leasing, hedging or research and development services with the company (consistent with the scope of FIN 46, as discussed below).

10. A guarantee contract refers to any obligation under a guarantee contract that has the characteristics identified in FIN 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. It would include contracts such as standby letters of credit, performance guarantees, indemnification agreements and keepwell agreements. Those guarantee contracts excluded from the provisions of FIN 45 are also excluded from the definition under this rule.
11. Material variable interests in unconsolidated entities include those with any of the characteristics identified in FIN 46, *Consolidation of Variable Interest Entities*. It applies only to material variable interests that provide financing, liquidity, market risk or credit risk support to the registrant, or engage in leasing, hedging or research and development services with the registrant.
12. The rules require disclosure of off-balance sheet arrangements that either have, or are reasonably likely to have, a current or future effect on a company's financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.
13. Generally, the disclosures should cover the most recent fiscal year. However, the discussion should address changes from the previous year where necessary to an understanding of the disclosure.
14. The specific disclosure requirements are less prescriptive than what was proposed, and are only required to the extent necessary to an understanding of a company's off-balance sheet arrangements. They include the following:
 - a. The nature and business purpose of the off-balance sheet arrangements;
 - b. The importance of the company's off-balance sheet arrangements to its liquidity, capital resources, market risk support, credit risk support or other benefits;
 - c. Insight into the overall magnitude of a company's off-balance sheet activities. Disclosure is required to the extent material and necessary to an investor's understanding of:
 - The amounts of revenues, expenses and cash flows arising from off-balance sheet arrangements;
 - The nature and total amount of any interests retained, securities issued and other indebtedness incurred in connection with such arrangements; and
 - The nature and amount of any other material obligations or liabilities (including contingent obligations or liabilities) arising from such arrangements and the triggering events or circumstances that could cause them to arise; and
 - d. Any known event, demand, commitment, trend or uncertainty that will, or is reasonably likely to, result in the termination, or material reduction in availability to the company, of off-balance sheet arrangements that provide material benefits to the company, and the course of action that will be taken or is planned in response to any such circumstances.
15. In analyzing and disclosing off-balance sheet arrangements, those with common or similar effects should be aggregated to the extent aggregation increases understanding.
16. Disclosure about an off-balance sheet arrangement is not required until an unconditionally binding definitive agreement exists or, if there is no such agreement, when settlement of the transaction occurs.

Interpretations and Implementation Considerations

- a. *The rules do not specifically cover the interim period MD&A requirements related to off-balance sheet arrangements. The general approach to interim period MD&As in Item 303(b) of Regulations S-K and S-B is to require registrants to describe material changes. The Commission took this approach to updating the new contractual obligations disclosure. Therefore, it appears that in interim MD&As registrants need not repeat the disclosure about off-balance sheet arrangements, but should update it to communicate material changes.*

Contractual Obligations

17. New Item 303(a)(5) of Regulation S-K and companion requirements in Forms 20-F and 40-F require tabular disclosure about contractual obligations. The requirements cover both on- and off-balance sheet items. Small business issuers are not subject to these requirements but are encouraged to provide this information.
18. The tabular disclosure must present aggregate amounts due, by category, for the following categories of obligations:
 - a. Long-term debt;
 - b. Capital lease obligations;
 - c. Operating leases;
 - d. Purchase obligations; and
 - e. Other long-term obligations reflected on the balance sheet.
19. Amounts due in less than one year, one to three years, three to five years, and more than five years must be provided for each category.
20. In addition, the table should be accompanied by footnotes necessary to describe material contractual provisions or other material information to the extent necessary for an understanding of the timing and amount of the contractual obligations.
21. The first three categories are defined by reference to the relevant U.S. GAAP accounting pronouncements.
22. A “purchase obligation” is defined in the rules as an agreement to purchase goods or services that is enforceable and legally binding on the company and that specifies all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction. If the purchase obligations are subject to variable pricing provisions, estimates of payments due must be provided in a footnote to the table. The footnotes to the table should also discuss any material termination or renewal provisions.
23. In interim periods, a company only needs to disclose material changes in its contractual obligations since the prior year-end. The table does not need to be provided.

Interpretations and Implementation Considerations

- a. *The rules are not specific regarding the items to be included in the purchase obligations or the other long-term obligations lines in the table. We understand that the SEC staff expects each management to use judgment and prepare a table that best informs readers about the company’s aggregate future cash payment requirements and believes that a key element of the table will be the footnotes explaining how the table was constructed.*
- b. *Companies should begin to consider the items they should present in the table and the processes they will need to develop to gather the information. For example:*
 - *For the purchase obligations line, companies may need to develop processes to accumulate obligations related to uncompleted contracts, where no liability has been reflected on the balance sheet.*
 - *For the purchase obligations line, companies will also need to consider how they should communicate cash payment requirements related to completed contracts, where liabilities (i.e., accounts payable, accruals, etc.) are reflected on the balance sheet. Alternatives might range from (1) presenting none of these items in the table and discussing them in a footnote to (2) including in the table all current liabilities with the attributes reflected in the definition. In that regard, it should be noted that some liabilities (e.g., deferred revenue, contingent liabilities) may not meet the definition of a purchase obligation.*
 - *Regarding the other long-term obligations line, companies should consider the extent to which they have items that they should present on this line and whether they need to*

enhance their processes to be able to schedule the payment requirements with sufficient precision. Examples of such items might include pensions, other postretirement benefits, and income taxes.

* * * * *

24. While the off-balance sheet disclosures must be presented in a separately captioned section of MD&A, the table of contractual obligations may be placed in any MD&A location that management deems appropriate.
25. To the extent that the information required for off-balance sheet arrangements is included in the footnotes to the financial statements, the MD&A disclosure may cross-reference to the footnotes.
26. The final rules for both off-balance sheet arrangements and contractual obligations apply to foreign private issuers that file annual reports on Form 20-F or on Form 40-F. However, since foreign private issuers are not required to file interim reports with the Commission, they will not be required to update their MD&A disclosures more frequently than annually unless they file a Securities Act registration statement that must include interim period financial statements and related MD&A disclosures.
27. The amendments relating to disclosures required by this release will supersede the guidance in the FR-61 on disclosure of off-balance sheet arrangements and contractual obligations as of the compliance dates for those amendments. The SEC assumes that registrants with fiscal years ending before the compliance dates will continue to follow the guidance in FR-61. Registrants may voluntarily comply with the new disclosure requirements before the compliance dates.
28. Registrants must comply with the off-balance sheet arrangement disclosure requirements in registration statements, annual reports and proxy or information statements that are required to include financial statements for their fiscal years ending on or after June 15, 2003. Registrants (other than small business issuers) must include the table of contractual obligations in registration statements, annual reports, and proxy or information statements that are required to include financial statements for the fiscal years ending on or after December 15, 2003.
29. To encourage the type of information and analysis necessary for investors to understand the impact of off-balance sheet arrangements and to reduce the burden of estimating the payments due under contractual obligations, the amendments include a safe harbor for forward-looking information. It specifies that, except for historical facts, the disclosure would be deemed to be a “forward looking statement” as that term is defined in the statutory safe harbors. In addition, with respect to the MD&A discussion of off-balance sheet arrangements, the “meaningful cautionary statements” element of the statutory safe harbors will be satisfied if all of the disclosure requirements with respect to off-balance sheet arrangements are met.

9. SEC Rule – Conditions for Use of Non-GAAP Financial Measures (Release No. 33-8176 and No. 33-8216)

1. These rules implement the provisions of Section 401(b) of the Act regarding the presentation of “pro forma” amounts in public disclosures.
2. The final rules address disclosure issues related to “non-GAAP financial measures” in three ways:
 - a. New Regulation G covers public disclosures that include non-GAAP financial measures, both disclosures that are filed with the SEC and disclosures that are not filed. It requires public companies that disclose non-GAAP financial measures to provide specified information.
 - b. Amendments to Regulations S-K and S-B and Form 20-F cover disclosures in SEC filings. They require more extensive disclosures than those in Regulation G. They also prohibit companies from presenting certain types of non-GAAP measures in SEC filings.

- c. Amendments to Form 8-K require companies to furnish the text of earnings releases and announcements with the SEC, regardless of whether the release includes a non-GAAP financial measure.
3. The proposed rules would have had the indirect effect of prohibiting domestic companies from including certain types of non-GAAP measures in earnings releases. This is because certain non-GAAP measures are prohibited in SEC filings, and the proposed rules would have required domestic companies to file the text of their earnings releases with the SEC on Form 8-K. The final rules do not prohibit companies from including these measures in their earnings releases. The final rules contain similar prohibitions on including certain measures in SEC filings, but they do not require domestic companies to file their earnings releases. Instead, domestic companies are required to furnish their earnings releases to the SEC on Form 8-K. Furnishing, rather than filing, earnings releases also means that earnings releases will not be incorporated by reference into other Commission filings unless the registrant specifically chooses to do so. Also, they will not be subject to certain liability provisions of the Exchange Act.
4. The staff has published a frequently asked questions document (FAQ) regarding the rules. The FAQ can be found at <http://www.sec.gov/divisions/corpfin/faqs/nongaapfaq.htm>. The FAQ addresses 33 questions. These questions cover the following topics:
 - a. Transition issues
 - b. Business combination transactions
 - c. Item 10(e) of Regulation S-K
 - d. EBIT and EBITDA
 - e. Segment Information
 - f. Item 12 of Form 8-K
 - g. Foreign Private Issuers
 - h. Voluntary filers

Definition of Non-GAAP Financial Measure

5. Regulation G and the amendments to Regulations S-K and S-B define a “non-GAAP financial measure” as a numerical measure of historical or future financial performance, financial position or cash flow that:
 - a. Excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet or statement of cash flows (or equivalent statements); or
 - b. Includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the comparable GAAP measure.
6. For purposes of the definition, GAAP refers to the principles under which the issuer’s primary financial statements are prepared.
7. Examples of non-GAAP financial measures include:
 - a. A measure of operating income that excludes one or more expense or revenue items that are identified as “non-recurring;” and
 - b. EBITDA
8. An example of a ratio that would be a non-GAAP financial measure is a measure of operating margin where any of the components of the calculation are not in accordance with GAAP.
9. Non-GAAP financial measures do not include:
 - a. Operating and other statistical measures (such as unit sales, numbers of employees, numbers of subscribers or numbers of advertisers);
 - b. Financial measures required to be disclosed by GAAP, SEC rules, or a system of regulation of a government or governmental authority or self-regulatory organization that is applicable to the

registrant (e.g., measures of capital or reserves calculated for such a regulatory purpose). However, a non-GAAP financial measure should be presented outside of the financial statements unless it is required or expressly permitted by the standards pursuant to which the financial statements were prepared;

- c. Ratios or statistical measures that are calculated using only:
 - Financial measures calculated in accordance with GAAP; and
 - Operating measures or other measures that are not non-GAAP financial measures.
10. Examples of ratios and measures that would not be non-GAAP financial measures would include sales per square foot or same store sales (in both cases assuming sales are calculated in accordance with GAAP).

Regulation G

11. Regulation G applies to any entity, including a foreign private issuer, which is required to file Exchange Act reports, other than a registered investment company.
12. Regulation G applies to all public announcements that contain non-GAAP financial measures, except for announcements subject to the SEC's communication rules relating to a proposed business combination. It applies whether the announcement is released through print, orally, Internet or broadcast means.
13. Under Regulation G, companies are prohibited from using non-GAAP financial measures that, taken together with the information accompanying that measure and any other accompanying discussion of that measure, contain an untrue statement or a material fact or omit a material fact necessary in order to make the presentation of the non-GAAP financial measure, in light of the circumstances under which it is presented, not misleading. This requirement applies whether the disclosure is filed with the SEC or not.
14. Regulation G requires the following as part of the disclosure or release of the non-GAAP financial measure:
 - a. A presentation of the most directly comparable financial measure calculated and presented in accordance with GAAP; and
 - b. A reconciliation (by schedule or other clearly understandable method) of the differences between the non-GAAP financial measure presented and the most directly comparable financial measure or measures calculated and presented in accordance with GAAP.
15. If a company includes a non-GAAP financial measure in a ratio, it must reconcile each non-GAAP financial measure used in the calculation. It must also show the ratio or measure as calculated using the most directly comparable GAAP financial measure(s).
16. With regard to forward-looking information, if the GAAP financial measure is not accessible on a forward-looking basis, the registrant must disclose that fact and provide reconciling information that is available without unreasonable effort. The registrant must also identify the information that is not available and disclose its probable significance.
17. For foreign private issuers whose securities are listed or quoted on a securities exchange or inter-dealer quotation system that is outside the U.S., Regulation G does not apply in certain circumstances. It does not apply if:
 - a. The disclosure is made by or on behalf of the foreign private issuer outside the U.S., or is included in a written communication that is released outside the U.S.; and
 - b. The non-GAAP financial measure is not derived from or based on a measure calculated and presented in accordance with U.S. GAAP.
18. If these conditions are met, the exemption from Regulation G applies even if:
 - a. A written disclosure is released in the U.S. as well as outside the U.S., as long as the communication is released in the U.S. contemporaneously with or after the release outside the U.S. and is not otherwise targeted at persons located in the U.S.;

- b. Foreign or U.S. journalists or other third parties have access to the information;
 - c. The information appears on the issuer's website so long as the website is not available exclusively to, or targeted at, persons located in the U.S.; or
 - d. Following disclosure or release of the information outside the U.S., it is included in a submission on Form 6-K.
19. If a non-GAAP financial measure is released orally, telephonically, by webcast, by broadcast, or by similar means, the disclosure requirements will be met if the company provides the disclosures by posting them on its website, provided the location and availability of the information is disclosed during the presentation.

Interpretations and Implementation Considerations

- a. *An example of a forward-looking non-GAAP financial measure for which the GAAP measure is not accessible might be earnings excluding impairment charges. A company might be able to forecast and desire to disclose this amount. The company might not be able to forecast future impairment charges or GAAP earnings after such charges.*
- b. *See the SEC staff's FAQ for further guidance.*

Amendments to Regulations S-K and S-B and Form 20-F

20. In addition to complying with Regulation G, registrants who present non-GAAP measures in SEC filings must comply with the amendments to Regulations S-K and S-B and Form 20-F.
21. These amendments require more extensive and detailed disclosures than Regulation G. They also prohibit certain non-GAAP financial measures in SEC filings. Filers on Form 40-F under the Multi-Jurisdictional Disclosure System are not subject to these requirements.
22. The rules do not apply to registered investment companies.
23. When companies disclose non-GAAP measures in SEC filings, they must provide:
- a. A presentation, with equal or greater prominence, of the most directly comparable financial measure calculated and presented in accordance with GAAP;
 - b. A reconciliation (by schedule or other clearly understandable method) of the differences between the non-GAAP financial measure disclosed or released with the most directly comparable financial measure or measures calculated and presented in accordance with GAAP;
 - c. A statement disclosing the reasons why the company's management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the company's financial condition and results of operations; and
 - d. To the extent material, a statement disclosing additional reasons, if any, for which the company's management uses the non-GAAP financial measure that are not otherwise disclosed.
24. In addition, a registrant must not:
- a. Exclude charges or liabilities that required, or will require, cash settlement from non-GAAP liquidity measures (EBIT and EBITDA measures are excluded from this prohibition; however, companies must reconcile these measures to their most directly comparable GAAP financial measure);
 - b. Adjust a GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, when (1) the nature of the charge or gain is such that it is reasonably likely to recur within two years, or (2) there was a similar charge or gain within the prior two years;
 - c. Present non-GAAP financial measures on the face of the financial statements or in the accompanying notes;
 - d. Present non-GAAP financial measures on the face of any pro forma financial information required to be disclosed by Article 11 of Regulation S-X; and
 - e. Use titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, titles or descriptions used for GAAP financial measures.

25. For foreign private issuers, a non-GAAP financial measure that would otherwise be prohibited will be permitted if the measure:
 - a. Relates to the GAAP used in the registrant's primary financial statements included in its filing;
 - b. Is required or expressly permitted by the GAAP under which the issuer's primary financial statements are prepared; and
 - c. Is included in the foreign private issuer's annual report used in its home country jurisdiction or market.
26. The Commission had proposed prohibiting registrants from presenting a non-GAAP per share measure in an SEC filing. The final rules contain no such restriction. (However, it should be noted that Statement No. 95 and ASR 142 prohibit the use of cash flow per share measures.)

Interpretations and Implementation Considerations

- a. *Some registrants disclose in their segments footnotes measures that would meet the definition of a non-GAAP financial measure if not for the exception in the definition pertaining to measures disclosed pursuant to GAAP. We understand that as long as a measure in a segments footnote is reconciled to the consolidated total in accordance with paragraph 32 of Statement 131, a registrant discussing that measure in MD&A need not provide a reconciliation in MD&A. Of course, the discussion in MD&A should comply with the requirements of FRR 54 (Section 501.06.a of the Codification of Financial Reporting Releases, at footnote 28), which states:
[T]he Commission expects that the discussion of a segment whose profitability is determined on a basis that differs from consolidated operating profit as defined by GAAP or that excludes the effects of items attributable to the segment also will address the applicable reconciling items in Management's Discussion and Analysis. For example, if a material charge for restructuring or impairment relates to a specific segment, but is not included in management's measure of the segment's operating profit or loss, registrants would be expected to discuss in Management's Discussion and Analysis the applicable portion of the charge, the segment to which it relates and the circumstances of its incurrence. Likewise, the Commission expects that the effects of management's use of non-GAAP measures, either on a consolidated or segment basis, will be explained in a balanced and informative manner, and the disclosure will include a discussion of how that segment's performance has affected the registrant's GAAP financial statements.*
- b. *With respect to the prohibition on adjusting a GAAP performance measure to eliminate or smooth items identified as non-recurring, infrequent or unusual, we understand that the SEC staff believes registrants should view the nature of a charge or gain broadly in evaluating the similarity of past items and the likelihood that items of that nature will recur. For example, we understand that a registrant should not exclude a goodwill impairment charge (even if it represents all goodwill related to a particular subsidiary) if it has other goodwill on its balance sheet unless it can conclude that it is not reasonably likely that it will have another goodwill impairment within two years. We also understand that a registrant may not avoid this prohibition by simply labeling an excluded charge or gain as something other than non-recurring, infrequent, or unusual.*
- c. *With respect to the prohibition on adjusting a GAAP performance measure to eliminate or smooth items identified as non-recurring, some registrants present measures that exclude charges or gains that are recurring. For example, a registrant might present operating income excluding the elements of pension expense other than service cost. The registrant does not exclude the other elements of pension expense because it views them as non-recurring. Instead, it excludes them because it believes they are not relevant to evaluating the company's operating*

- performance. The SEC staff has informally indicated that it would probably not object to such measures, as long as the disclosure does not imply that the excluded items are non-recurring and the explanation of why the measure is meaningful is credible. The staff has also indicated, however, that it expects that there would be few measures for which the explanation would be credible. This guidance is relevant to registrants that use EBIT or EBITDA as non-GAAP measures of **operating performance**. Question 8 of the FAQ indicates that the rule does not prohibit a registrant from excluding recurring items, such as interest, taxes, depreciation and amortization, from a performance measure. However, it does point out the high hurdles a registrant must meet to justify the use of a measure that excludes **recurring** items. Question 15 indicates that if a registrant that can justify the use of EBIT or EBITDA as a measure of **operating performance**, it should reconcile to net income.
- d. If a financial measure is required or expressly permitted by the GAAP under which the issuer's primary financial statements are prepared, a registrant may present the measure on the face of its financial statements or in the footnotes. "Required or expressly permitted" is a higher standard than "not prohibited."
 - e. The prohibition on presenting cash flow per share measures effectively prohibits registrants from presenting non-GAAP per share measures of liquidity. This is because the GAAP measure to which these measures would need to be reconciled (cash flow per share) cannot be presented. Any non-GAAP per share measure presented must be characterized as a measure of operating performance and reconciled to earnings per share.
 - f. Item 10(e)(1)(i)(C) requires "[a] statement disclosing the reasons why the registrant's management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the registrant's financial condition and results of operations." The staff has noted that historically, registrants have frequently failed to adequately communicate this. For example, registrants frequently provide explanations of the usefulness of a non-GAAP measure that would apply equally to the comparable GAAP measure. When the explanation would apply equally to the comparable GAAP measure, the staff does not believe a registrant has met the disclosure burden reflected in this rule. The staff emphasized that meeting this disclosure burden will not be possible in many cases, and it may require a significant change in mindset for many registrants. In the FAQ, the staff notes that since this requirement also applies to earnings releases furnished under Item 12 of Form 8-K, this may also be an issue for earnings releases. Several questions in the FAQ address this disclosure burden. See Questions 8, 9, 10, and 13.
 - g. Item 10(e)(1)(ii)(A) of Regulation S-K specifically permits registrants to use EBIT and EBITDA as non-GAAP **liquidity** measures. In Question 14 of the FAQ, the staff clarified that the "earnings" number that is the "E" in these calculations is intended to mean net income as stated in the statement of operations under GAAP. The staff has also informally indicated that the "amortization" number that is the "A" in the EBITDA calculation should include only amortization of items that would be appropriately reported as amortization expense on the face of the income statement (i.e., amortization of intangible assets). It should not include items that would be reported on other lines, such as amortization of prepaid expenses or deferred stock compensation expense. The staff has confirmed that when a registrant uses EBIT or EBITDA as a **liquidity** measure, the "most directly comparable" GAAP measure that a registrant must present and reconcile to pursuant to Regulation G and Item 10(e) of Regulation S-K is cash flows from operating activities – not a measure reflected on the income statement. This will require a significant change in practice for many registrants.
 - h. See the SEC staff's FAQ for further guidance on the matters discussed above and other issues.

New Item 12 of Form 8-K

27. New Item 12 of Form 8-K, “Disclosure of Results of Operations and Financial Condition,” requires domestic companies that disclose material non-public information regarding the company’s results of operations or financial condition for an annual or quarterly fiscal period that has ended to furnish that information to the SEC on Form 8-K within five business days of any public announcement or release of such information.
28. Issuers that make earnings announcements in an interim or annual report to shareholders would be allowed to specify in Form 8-K which portion of that report contains the required information.
29. The Form 8-K filing will satisfy the requirements under Regulation FD if it is made within the time frame required by Regulation FD.
30. The filing requirements would not apply to public disclosures that only include earnings estimates for periods that have not been completed or future fiscal periods.
31. If a non-GAAP financial measure is included in the information furnished under Item 12 of Form 8-K, the requirements of Regulation G would apply. In addition, Item 12 of Form 8-K incorporates certain requirements of Regulations S-K and S-B, Item 10, which require the following to be provided:
 - a. A presentation, with equal or greater prominence, of the most directly comparable financial measure calculated and presented in accordance with GAAP;
 - b. A reconciliation (by schedule or other clearly understandable method) of the differences between the non-GAAP financial measure disclosed or released with the most directly comparable financial measure or measures calculated and presented in accordance with GAAP;
 - c. The reasons why the company’s management believes that presentation of the non-GAAP financial measure provides useful information to investors regarding the company’s financial condition and results of operations; and
 - d. To the extent material, the additional purposes, if any, for which the company’s management uses the non-GAAP financial measure that are not otherwise disclosed.
32. If non-public information is disclosed orally, telephonically, by webcast, broadcast, or similar means, Item 12 would not require filing of a Form 8-K if:
 - a. The information is provided as part of a presentation that is complementary to, and initially occurs within 48 hours after, a related written announcement or release that has been furnished on Form 8-K pursuant to Item 12 prior to the presentation;
 - b. The presentation is broadly accessible to the public by dial-in conference call, webcast or by similar means;
 - c. The financial and statistical information contained in the presentation is provided on the registrant’s website, together with any information that would be required under proposed Regulation G; and
 - d. The presentation was announced by a widely disseminated press release that included instructions as to when and how to access the presentation and the location on the registrant’s website where the information would be available.

Interpretations and Implementation Considerations

- a. *Regulation G already requires a reconciliation to be included in the earnings release. The commentary in the release states that the explanation why management believes the non-GAAP measure provides useful information and the additional purposes for which management uses the measures may be provided by including the disclosure in the Form 8-K or in the text of the earnings release that is filed as an exhibit. This information may also be provided in the most recent annual report (or a subsequent filing). With respect to the requirement for equal prominence, it appears that in order to meet this requirement, a registrant would need to*

present the GAAP measure and the non-GAAP measure with equal prominence in the earnings release.

- b. See the SEC staff's FAQ for further guidance.*

Effective Dates

33. Regulation G applies to all disclosures of non-GAAP financial information (including disclosures made in SEC filings) made on or after March 28, 2003. The amendments to Item 10 of Regulation S-K and S-B and Form 20-F apply to quarterly or annual reports filed with respect to a fiscal period ending after March 28, 2003. The requirement to furnish earnings releases on Form 8-K applies to announcements made after March 28, 2003. In Release No. 33-8216, the SEC stated that it has not made the necessary programming changes to the EDGAR filing system to permit it to receive filings under new Item 12 of Form 8-K. The Commission instructed registrants to temporarily furnish the information required by Item 12 under Item 9 ("Regulation FD Disclosure") of Form 8-K.

Interpretations and Implementation Considerations

- a. Although the amendments to Item 10 of Regulations S-K and S-B and Form 20-F do not apply to calendar 2002 annual reports, new Regulation G does apply to a calendar 2002 annual report if it is filed on March 28, 2003 or later. Thus, if a company includes a non-GAAP financial measure in a calendar 2002 Form 10-K, Form 10-KSB, Form 20-F, or Form 40-F and files that report on March 28 or later, it must present the most directly comparable GAAP measure and provide a reconciliation in that report.*
- b. Some companies may plan to file registration statements on or after March 28, 2003 that will incorporate by reference periodic reports filed before March 28. These companies should consider whether their previously filed periodic reports comply with Regulation G. This is because the SEC staff has indicated that a registration statement filed on March 28, 2003 cannot incorporate by reference a disclosure of a non-GAAP financial measure that does not comply with Regulation G. If a company must incorporate by reference a periodic report that includes a disclosure that does not comply with Regulation G, it must bring that prior disclosure into compliance. The SEC staff has indicated that a company can do this by (1) amending the prior report, (2) filing the compliant disclosure on a Form 8-K and incorporating it by reference in the registration statement, or (3) presenting the compliant disclosure in the registration statement. However, the SEC staff has granted relief for filings on Form S-8.*
- c. Many companies have effective registration statements covering offerings that either have not yet commenced or are ongoing (e.g., delayed shelf offerings registered on Form S-3, secondary offerings, offerings of securities pursuant to employee compensation arrangements registered on Form S-8, etc.). The SEC staff has informally indicated that the change in disclosure requirements resulting from these new rules would not result in a fundamental change for a company whose registration statement presents or incorporates by reference a non-GAAP financial measure that does not comply with the new rules.*
- d. See the SEC staff's FAQ for further guidance on the matters discussed above and other transition issues.*

10. SEC Rule – Ownership Reports and Trading by Officers, Directors and Principal Security Holders (Release No. 34-46421)

1. Previously, Section 16(a) of the Securities Exchange Act of 1934 provided for changes in ownership of "reporting persons" or "insiders" to be reported (on Form 4) on a monthly basis within 10 days after the close of each calendar month in which the change in ownership occurred.

2. Section 403(a) of the Sarbanes-Oxley Act amended Section 16(a) to require reports on ownership changes to be filed “before the end of the second business day following the day on which the subject transaction was executed, or at such other time as the Commission shall establish, by rule, in any case in which the Commission determines that such two-day period is not feasible.”
3. On August 27, 2002, the SEC adopted rule and form amendments to implement Section 403 of the Sarbanes-Oxley Act. The amendments apply to transactions that occur on or after August 29, 2002.
4. Certain previous transactions no longer are reportable on a deferred basis on Form 5, but instead must be reported on Form 4 within two business days.

11. SEC Rule– Mandated Electronic Filing and Website Posting for Forms 3, 4 and 5 (Release No. 33-8230)

1. In accordance with Section 403 of the Act, the SEC has adopted rule and form amendments to mandate the electronic filing, and website posting by issuers with corporate websites, of beneficial ownership reports filed by officers, directors and principal security holders under Section 16(a) of the Securities Exchange Act of 1934.
2. The rules became effective on June 30, 2003, one month before the statutory deadline. Issuers must comply with the website posting requirements for beneficial ownership reports filed on or after June 30, 2003.
3. Section 16 applies to every person who is a beneficial owner of more than 10% of any class of equity securities registered under Section 12 of the Exchange Act and each officer and director (collectively, “reporting persons” or “insiders”) of the issuer of the security.
 - a. Securities registered by foreign private issuers are not subject to Section 16.
4. As discussed above, effective August 29, 2002, the Act requires insiders to file reports on ownership changes within two business days.
5. Previously, insiders could file reports on Forms 3, 4 and 5 on paper or electronically through EDGAR.
6. The rules amend Regulation S-T to require insiders to file Forms 3, 4 and 5 with the SEC on EDGAR.
 - a. In May 2003, a new system for filing these forms went live. The new system makes it easier to locate and search for the data in these forms.
 - b. In order to file forms using the new system, persons will need the same codes as are required to file on EDGARLink (a Central Index Key, or CIK, and a CIK confirmation Code, or CCC.)
 - c. If a filing is made on behalf of multiple insiders, each insider will be required to have a CIK and CCC. Multiple insiders will be allowed to report on a single form only if they all have an interest in a transaction or holding reported.
 - d. The Commission’s website has a frequently asked questions document (FAQ) that contains information about how the new system works (<http://www.sec.gov/divisions/corpfin/sec16faq.htm>).
 - e. As a result of the new system, EDGARlink filing is no longer available for these forms.
7. The rules extend the filing hours for submitting Forms 3, 4, and 5.
 - a. Previously, all electronic filings had to be submitted by 5:30 p.m. Eastern Time to be considered filed that day.
 - b. The new rules extend the deadline for Form 3, 4, and 5 (but not other forms) to 10:00 p.m.
8. The rules provide temporary limited relief from the requirement that companies disclose late Section 16 reports in their proxy statements and annual reports. For the first year the new rules are in effect, companies need not disclose Form 4 filings that are no more than one day late.
 - a. In light of this provision, as well as the extended filing deadline, temporary hardship exemptions will be unavailable for these forms.

- b. A filer may request a filing date adjustment under Rule 13(b) of Regulation S-T. This rule addresses circumstances where an electronic filer attempts in good faith to file a document with the Commission on a timely basis but the filing is delayed due to technical difficulties beyond the filer's control. The SEC staff may grant a filing date adjustment if it appears that the adjustment is appropriate and consistent with the public interest and the protection of investors.
9. The rules also require an issuer that maintains a corporate website to post on its website all Forms 3, 4 and 5 filed with respect to its equity securities by the end of the business day after filing. An issuer can satisfy this requirement whether it provides access directly or by hyperlinking to the reports via a third-party service if certain conditions are met.
 - a. Forms must be posted on the issuer's website for at least a 12-month period.

12. SEC Rule – Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports (Release No. 33-8238)

1. The rules in this release implement Section 404 of the Act, which requires the SEC to issue rules requiring management to evaluate and report on the effectiveness of a company's internal control structure and procedures for financial reporting in each annual report. Section 404 also requires a company's auditors to attest to, and report on, management's annual evaluation.
2. The rules in this release require the following:
 - a. Management to report on the company's internal control over financial reporting in each annual report.
 - b. A company's auditors to issue a report attesting to management's annual assessment of the company's internal control over financial reporting.
 - c. Management to disclose, each quarter, changes *during the quarter* in internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, the company's internal control over financial reporting (this is a modification of the previous requirement for management to disclose significant changes in internal controls that occurred *subsequent to* the date of their evaluation).
 - d. Management to evaluate and report on the company's disclosure controls and procedures *as of the end of each quarter* (this is a modification of the previous requirement for management to perform this evaluation as of a date within 90 days of the filing date of each periodic report).
 - e. Wording changes to the Section 302 certifications (see section 4 above) to conform them to the revised controls evaluation and reporting requirements.
 - f. Section 302 certifications (see section 4 above) to be filed as exhibits (previously, these certifications were provided immediately after the signatures in periodic reports).
 - g. Section 906 certifications (see section 1 above) to be furnished as exhibits (previously, there were no rules specifying how these certifications were to be provided, and they were provided in a variety of ways).
3. In response to the many comments the SEC received on its October 2002 proposal, the final rules reflect several changes:
 - a. Delayed effective date – In recognition of the considerable amount of work required to implement the rules, for most companies they will take effect at a later date than had been proposed. The SEC had proposed that the requirements for a management report on internal control and an auditor attestation report would apply to calendar year companies in their 2003 annual reports. The final rules will require large domestic calendar year companies to provide these reports in their 2004 annual reports and other companies to provide them in their 2005 annual reports.

- b. Definition clarified – The internal controls covered by the rules have been defined in a manner that more closely follows the definition used by the Committee of Sponsoring Organizations of the Treadway Commission in its 1992 report (the COSO Report). The final rules use the term “internal control over financial reporting,” and the definition includes controls that pertain to maintenance of records, recording of transactions, and safeguarding of assets. Controls pertaining to efficiency of operations and compliance with laws are not included in the definition of internal control over financial reporting.
 - c. Established framework required – The final rules require management to make its internal control evaluation using a suitable, recognized control framework that has been established by a body or group that followed due process procedures in establishing the framework. In addition, the report on internal control must identify the framework used.
 - d. Less quarterly evaluation work required – The proposed rules suggested that a full evaluation and management report on internal control would be required each quarter. The final rules do not require a quarterly report. They require only that management evaluate each quarter (including the fourth quarter) any changes in internal control that occurred during the quarter and disclose those changes that have materially affected or are reasonably likely to materially affect the company’s internal control over financial reporting.
4. The rules apply to companies that file reports pursuant to Section 13(a) or 15(d) of the Exchange Act. Accordingly, the rules apply to small business issuers and foreign private issuers. Although registered investment companies (other than small business investment companies) are subject to new rules requiring them to maintain internal control over financial reporting, they are not subject to the new internal control evaluation and reporting requirements.
 5. The new rules are reflected in amendments to:
 - a. The following Exchange Act periodic report forms: Forms 10-K, 10-KSB, 20-F, 40-F, 10-Q, and 10-QSB (but not Form 11-K);
 - b. Regulations S-K and S-B (Item 307 was amended, a new Item 308 was created, and new exhibits were added to Item 601);
 - c. Exchange Act rules, principally Rules 13a-14, 13a-15, 15d-14, and 15d-15; and
 - d. Investment Company Act rules and Form N-CSR.
 6. In the amendments to Forms 10-K and 10-KSB, the Commission redesignated Item 14, Controls and Procedures, as new Item 9A of Form 10-K and Item 8A of Form 10-KSB.

Evaluation and Reporting Requirements

7. New Exchange Act Rules 13a-15(c) and 15d-15(c) require the management of each issuer, other than a registered investment company, to evaluate, with the participation of the issuer’s principal executive and financial officers, the effectiveness of the issuer’s internal control over financial reporting as of the end of each fiscal year.
8. The evaluations must be based on a framework that is a suitable, recognized control framework that has been established by a body or group that has followed due process procedures, including a broad distribution of the framework for public comment.
 - a. The COSO framework will satisfy the SEC’s criteria. However, the final rules do not mandate the use of a particular framework.
9. New Exchange Act Rules 13a-15(d) and 15d-15(d) require management to evaluate any change in the issuer’s internal control over financial reporting that occurred during each fiscal quarter (including the fourth quarter) that has materially affected, or is reasonably likely to materially affect, the issuer’s internal control over financial reporting.
 - a. New Item 308(c) of Regulations S-K and S-B requires disclosure of material changes in internal control over financial reporting that have occurred during a quarter (including the fourth quarter).

- b. The rules do not require a quarterly report on the effectiveness of a company's internal controls.
10. Amendments to Forms 10-K and 10-KSB require companies to include in their annual reports a report of management on the company's internal controls over financial reporting. The requirements for this report are outlined in new Item 308 of Regulations S-K and S-B. New companion rules in Forms 20-F and 40-F contain the same requirements. The report must include:
 - a. A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting;
 - b. A statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting;
 - c. Management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including a statement as to whether or not the company's internal control over financial reporting is effective. In this regard:
 - A negative assurance statement indicating that nothing has come to management's attention to suggest that the company's internal control over financial reporting is not effective will not be acceptable.
 - The report must include disclosure of any material weaknesses in the company's internal control over financial reporting.
 - Management is not permitted to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses.
 - It is the Commission's judgment that an aggregation of significant deficiencies could constitute a material weakness.
 - d. A statement that the registered public accounting firm that audited the company's financial statements has issued an attestation report on management's assessment of the company's internal control over financial reporting.
 - These rules also require a company to file the registered public accounting firm's attestation report as part of the annual report.
11. The rules do not specify where the internal control report must appear in the company's annual report. However, the SEC expects that companies will choose to place the report near the MD&A disclosure or in a portion of the document immediately preceding the financial statements.
12. The rules do not specify the methods for or procedures to be performed in evaluating internal control over financial reporting. However:
 - a. The rules referred to above state that in conducting the evaluation and developing an assessment of the effectiveness of internal control, a company must maintain evidential matter, including documentation, to provide reasonable support for management's conclusions.
 - b. The release states that inquiry alone will not provide an adequate basis for management's assessment. The assessment must be based on procedures sufficient to both:
 - Evaluate the design of the controls and
 - Test their operating effectiveness.
 - c. The procedures may be conducted by non-management personnel acting under the supervision of management.
13. The SEC's independence rules prohibit a company from relying on its auditors to perform the evaluation of the effectiveness of internal controls.
 - a. However, an auditor may assist its client in many ways with the work required to comply with the rules. For example, auditors may:
 - Assist management in documenting internal controls;
 - Provide software templates to help document controls or perform statistical sampling;
 - Note areas where management might wish to improve controls; and
 - Make suggestions to improve tests of controls

- b. However, it is management who must perform the evaluation. Management must:
 - Perform the evaluation and testing;
 - Exercise its own judgment in performing the analysis;
 - Make all final decisions; and
 - Be “in charge” of the work being done.
- 14. Section 404 of the Act stipulates that the attestation cannot be the subject of a separate engagement of a registered public accounting firm. Accordingly, new Rule 2-02(f) of Regulation S-X requires auditors who issue a report on a registrant’s financial statements included in an annual report to also issue a report attesting to management’s assertion regarding internal control.
 - a. The rule also specifies the technical requirements for the auditor’s attestation report.
 - b. The rule states that the attestation report may be separate from the accountant’s report.
- 15. The attestation standards to be used by auditors are those adopted in April 2003 by the PCAOB on a transitional basis.
 - a. Those standards are contained in Section AT 501 of the Codification of Statements on Standards for Attestation Engagements, *Reporting on an Entity’s Internal Control Over Financial Reporting*.
 - b. Any future standards adopted by the PCAOB will apply to these engagements.

Interpretations and Implementation Considerations

- a. *The PCAOB has made adopting a new standard covering these engagements a high priority, and it appears likely that new standards will be in place before auditors are required to perform these engagements.*
- b. *Since auditing standards have not previously required auditors to evaluate internal controls to this extent, it is likely that this requirement will add substantial time to most audits.*

Definition of Internal Control Over Financial Reporting

- 16. New Exchange Act Rules 13a-15(f) and 15d-15(f) define internal control over financial reporting as “a process designed by, or under the supervision of, the issuer’s principal executive and principal financial officers, or persons performing similar functions, and effected by the issuer’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:
 - a. Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
 - b. 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 issuer are being made only in accordance with authorizations of management and directors of the issuer; and
 - c. Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the issuer’s assets that could have a material effect on the financial statements.”
- 17. The definition is consistent with the description of internal accounting controls in Exchange Act Section 13(b)(2)(B).
- 18. The SEC’s rules adopted in August 2002 to implement Section 302 of the Act (see section 4 above) require a company’s principal executive and financial officers to certify as to their responsibility for establishing and maintaining disclosure controls and procedures and their evaluation of the effectiveness of those controls and procedures.

- a. The SEC believes that there is substantial overlap between a company's disclosure controls and procedures and its internal control over financial reporting. The Commission also believes that there are elements of each definition that are not subsumed by the other.
- b. Disclosure controls and procedures cover a broader range of information than covered by a company's internal control over financial reporting. Therefore, some disclosure controls (e.g., those related to non-financial information included in public reports) would not be part of a company's internal control over financial reporting.
- c. Other disclosure controls and procedures, such as controls that provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, are also components of internal control over financial reporting.
- d. However, some of an issuer's internal controls that pertain to accurate recording of transactions and safeguarding of assets might not be part of a company's disclosures controls and procedures.

Interpretations and Implementation Considerations

- a. *Regarding the question of whether a control that is part of a company's internal control over financial reporting is also part of its disclosure controls and procedures, the release discusses examples of safeguarding controls such as requiring dual signatures on checks or limiting the signature authority on checks. It states that a company with such safeguarding controls could determine that those controls are not part of disclosure controls and procedures.*
- b. *Conversely, a safeguarding control that might also constitute an element of a company's disclosure controls and procedures might be physical security controls over inventory, which are discussed in footnote 57 in the release. If management relies on this safeguarding control to achieve financial reporting that is in accordance with GAAP, the control will also be an element of the company's disclosure controls and procedures.*

Applicability to Various Types of Issuers

19. Small business issuers – These rules apply to small business issuers. As discussed further below, the Commission adopted a later compliance date for these issuers.
20. Foreign private issuers – These rules apply to foreign private issuers. As discussed further below, the Commission adopted a later compliance date for these issuers. In addition, foreign private issuers are not required to file quarterly reports. Therefore, the requirement to disclose changes in internal controls each quarter does not apply to them. These issuers need only disclose in the annual report the material changes to internal controls that have occurred during the period covered by the annual report.
21. Asset-backed issuers – These rules do not apply to issuers of asset-backed securities.
22. Bank and thrift holding companies – Such companies that are required to file reports under the Exchange Act are subject to the new internal control reporting requirements. However, since many bank and thrift holding companies prepare and file an internal control report with the FDIC, the final rules give these companies the option of preparing a single management report that satisfies both the FDIC and the SEC requirements. The report must contain specific statements, which are listed in the release, that address both the SEC and the FDIC requirements. In addition:
 - a. The company must provide the required auditor's attestation report.
 - b. For purposes of the internal control report and the attestation report, financial reporting must encompass both financial statements prepared in accordance with GAAP and those prepared for regulatory reporting purposes.
23. Registered investment companies – Section 404 of the Act does not apply to registered investment companies. However, the rules requiring a company's management to establish and maintain internal control over financial reporting do apply to registered investment companies (other than small

business investment companies) with respect to fiscal years ending on or after June 15, 2004. The rules and forms that implement the Section 302 certifications for registered investment companies have been amended to conform to the amendments adopted for operating companies.

Changes in Certification Requirements

24. The rules and forms implementing Section 302 certifications (see section 4 above) have been amended to conform those requirements with the changes outlined above. The changes are as follows:
- The officers must certify as to their responsibility for establishing and maintaining both disclosure controls and procedures *and* internal control over financial reporting.
 - The officers must certify that they have designed the registrant's internal control over financial reporting (or caused such internal control over financial reporting to be designed under their supervision) to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP.
 - The officers must certify that they have evaluated the effectiveness of the registrant's disclosure controls and procedures and reported those conclusions *as of the end of the period* covered by the report. (This is a modification of the previous requirement for management to perform this evaluation as of a date within 90 days of the filing date of each periodic report. The evaluation date was not changed for registered investment companies.)
 - The officers must certify that they have disclosed any change in the company's internal control over financial reporting that occurred *during the company's most recent fiscal quarter* that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting. (This is a modification of the previous requirement for officers to certify that they have disclosed significant changes in internal controls that occurred *subsequent to* the date of their evaluation.)
25. The SEC also adopted rules requiring companies (including foreign private issuers and investment companies) to provide the CEO and CFO certifications required by Sections 302 and 906 of the Act as exhibits to the periodic reports to which they relate. The amendments permit companies to "furnish" rather than "file" the Section 906 certifications.
- The Section 302 certification will be added as exhibit number 31 in the Regulation S-K and S-B Item 601 exhibit table; the Section 906 certification will be exhibit number 32.
 - In the event that the EDGAR system is not updated by the effective date, companies should submit both the Section 302 and 906 certifications as Exhibit 99.
 - Section 906 exhibits will be subject to the signature requirements of Regulation S-T. As a result, companies will be required to retain a manually signed signature page or other authenticating document for a five-year period.

Interpretations and Implementation Considerations

- With respect to Form 11-K annual reports filed by benefit plans, it is clear that Section 302 certifications are not required. However, it is not clear whether the Section 906 certification requirements apply.*
- We understand that the SEC staff has informally indicated that it believes that benefit plans are issuers and that Section 906 certifications are required in Form 11-K filings. The Commission is consulting with the Department of Justice on this and considering taking additional action.*

Effective Dates

26. The SEC delayed the effective dates for the evaluation and reporting on internal control in view of the effort required for companies and auditors to be in a position to meet these requirements. (The

Commission had proposed that this be required in annual reports for fiscal years ending on or after September 15, 2003.)

Interpretations and Implementation Considerations

- a. *In a recent speech given by Scott Taub, Deputy Chief Accountant of the SEC, Mr. Taub urged companies to recognize the effort required and begin immediately, stating, “The need to document the existing internal controls, consider whether other controls should be added, and design and perform tests of controls indicates that a lot of time is necessary in order for management to be in a position to conclude as to the effectiveness of the company’s internal control over financial reporting. Please do not use the extension of the compliance date as a reason to relax, take your eye off the ball, or otherwise not make use of the extra time you’ve been given. We listened to your concerns about timing, and we believe we’ve done our part to ensure an effective and smooth implementation of the rules, which is in the best interests of investors. If you don’t take advantage of this extra time to work on the implementation, you will not have done your part for investors.”*
27. The effective dates of the rules requiring companies to evaluate and report on internal control over financial reporting and provide an auditor’s attestation report in their annual reports are as follows:
- Companies that meet the definition of an “accelerated filer” (generally U.S. companies that have an equity market capitalization of over \$75 million and have filed an annual report with the SEC) will first be required to do so in their annual reports for fiscal years ending on or after June 15, 2004.
 - All other issuers, including foreign private issuers and small business issuers, will be required to do so in annual reports for fiscal years ending on or after April 15, 2005.
28. The requirement to *evaluate* changes in internal control over financial reporting on a quarterly basis is effective for a company’s first quarterly report after the first annual report required to include a management report on internal control over financial reporting.
- This requirement must be distinguished from the requirement to *report* significant changes in internal control over financial reporting on a quarterly basis *if* such changes are identified. The requirement to report such changes has been in effect for filings since August 29, 2002, pursuant to Item 307(b) of Regulations S-K and S-B. (Even though no formal evaluation of internal control over financial reporting has been required, registrants might identify such changes through their evaluations of disclosure controls and procedures or other means.) The requirement was changed to require reporting on significant changes *during* a quarter (rather than after the evaluation date) and was relocated to Item 308(c) of Regulations S-K and S-B. This change in the internal control changes to be reported is effective for periodic reports due on or after August 14, 2003 (even if the report is filed prior to that date).
29. The following rule changes also apply in periodic reports due on or after August 14, 2003 (even if the report is filed prior to that date):
- The requirement for management to evaluate and report on disclosure controls and procedures as of the end of the period covered by the report (vs. as of a date within 90 days of the filing date).
 - The requirement to change the wording of the Section 302 certifications to conform them to the revised controls evaluation and reporting requirements, with the following exceptions:
 - To accommodate the different compliance dates, a company’s certifying officers may temporarily modify the content of their Section 302 certifications to omit the references to internal control over financial reporting matters that have a delayed effective date. These portions of the certifications must be provided when the internal control evaluation and reporting requirements become effective.

- In that regard, the certifications may temporarily omit the references to (i) responsibility for establishing and maintaining internal control over financial reporting and (ii) having designed the registrant's internal control over financial reporting to provide reasonable assurance regarding reliable financial reporting.
- c. The requirements to file Section 302 certifications and furnish Section 906 certifications as exhibits.

Interpretations and Implementation Considerations

While the extended compliance dates give companies time to prepare for reporting on internal control over financial reporting, we agree with Mr. Taub's remarks quoted above indicating that complying will require significant effort and that companies should begin immediately. In addition to ensuring that a company is in position to comply with the rules, starting immediately may also provide practical benefits. We expect that this effort will enable many companies to identify and implement changes in their internal controls to strengthen them. Also, identifying significant deficiencies and material weaknesses early gives a company time to correct them before the evaluation date and reduces the risk that a company may need to report that its internal controls are not effective.

The steps a company should take to meet the new requirements are discussed below.

a. Commit the necessary time and resources.

- *A company should begin by making the project a high priority and assigning senior level management personnel to lead the effort. A company may find it helpful to establish a committee that will be responsible for executing the process of documenting, testing and evaluating the company's internal control over financial reporting. If the company has already established a disclosure committee that is responsible for evaluating disclosure controls and procedures, that committee's responsibilities could be extended to include those related to internal control over financial reporting. Like the disclosure committee, the internal control committee should report to senior management, including the certifying officers.*
- *A company must also realistically estimate the time and resources that will be required. In most cases, the effort required will be significant. In an informal survey conducted by Financial Executives International in May, respondents indicated "that their company employees would be spending an average of 6,700 hours evaluating and enhancing corporate internal controls this year, and that they expected additional spending averaging \$480,000 for such things as evaluation software, outside consulting and employee training." The results are based on 83 responses from public companies with annual sales revenue averaging \$3.27 billion. (These costs do not include amounts to be paid to auditors for their attestation.) In addition to having sufficient available time, the people who will perform the work must have the appropriate skills and training.*
- *A company should decide whether it has sufficient internal resources to handle the job or whether external resources will also be needed. Although many qualified service providers are available to participate in these efforts, the demand for their services is currently quite strong.*
- *Whether a company performs the work itself or uses an outside service provider, it should review the approach to be taken and the work to be performed with its auditor to ensure that it will provide an appropriate basis for the auditor to provide an attestation report.*

b. Select a Suitable Internal Control Framework

- *The model recommended by COSO is the one that seems to be most widely recognized.*

- *The COSO manual entitled Internal Control – Integrated Framework and related tools can be purchased from the Institute of Internal Auditors (IIA) for \$33 per copy. The IIA can be reached at www.theiia.org or 1-877-867-4957.*
- c. *Identify and Document Existing Controls*
 - *In performing this step, a company should build on its existing documentation of internal controls, including its documentation of the disclosure controls that management determines are part of internal control over financial reporting.*
- d. *Evaluate Design Effectiveness of Controls*
 - *If the company has not established effective controls to achieve a particular objective, it must design and install effective controls.*
- e. *Design and Perform Tests to Evaluate Operating Effectiveness of Controls*
 - *In this step, a company should determine whether the controls it has established are operating as intended. Again, the work already being performed to evaluate the operating effectiveness of the company's disclosure controls and procedures should be utilized where those controls overlap with the company's internal control over financial reporting.*
- f. *Evaluate Controls and Implement Changes*
 - *As a result of the evaluation and testing described above, management should be in a position to assess whether existing controls are adequate to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP.*
 - *Where weaknesses or deficiencies exist, a company should implement changes and subsequently test the changed or additional controls before the date of the first year-end evaluation upon which the company must report externally.*
- g. *Monitor Existing Controls and Material Changes*
 - *Management must also establish procedures for monitoring the effectiveness of existing controls, identifying and documenting changes, and evaluating the materiality of the changes on a quarterly basis.*

13. SEC Rule – Disclosure Required by Section 406 of the Sarbanes-Oxley Act of 2002 (Code of Ethics) (Release No. 33-8177)

1. These rules implement the requirements of Section 406 of the Act requiring disclosures regarding the company's code of ethics for its senior financial officers.
2. The new rules were adopted substantially as proposed. While the Act requires that a complying company's code of ethics cover only the senior financial officers, the rules expanded this group to include a company's chief executive officer.
3. The rules apply to domestic (including small business issuers) as well as foreign private issuers. The rules do not apply to registered investment companies. (The SEC adopted similar rules for investment companies. Those new rules are contained in Release 34-47262.)
4. The rules require companies to disclose the following in their annual report:
 - a. Whether the company has adopted a written code of ethics that applies to the company's principal executive officer, principal financial officer, principal accounting officer or controller or persons performing similar functions; and
 - b. If the company has not adopted such a code of ethics, the reasons why it has not done so.
5. A company must make its codes of ethics publicly available and has three alternatives in doing so:
 - a. File a copy as an exhibit to its annual report on Form 10-K, 10-KSB, 20-F or 40-F;

- b. Post the text of its code of ethics, or the portion that specifically relates to its senior financial officers and principal executive officer, on its website. If this option is chosen, the company must disclose its website address and intention to provide disclosure in this manner in its annual report; or
 - c. Provide an undertaking in its annual report to provide a copy of its code of ethics to any person without charge upon request.
6. New Item 10 of Form 8-K requires a domestic company to report the following within five business days after the event occurred:
 - a. The nature of any change to a company's code of ethics that applies to the specified officers; or
 - b. The nature of any waiver, including an implicit waiver, of an ethics code provision for a specified officer, including the name of the person to whom the waiver was granted and the date of the waiver.
7. Only amendments or waivers relating to the specified elements of the code of ethics and the specified officers must be disclosed. For example, an amendment to a provision affecting only directors would not require disclosure.
8. As an alternative to filing a Form 8-K, a company can instead disseminate the required information regarding amendments or waivers using its Internet website.
 - a. To take advantage of this option, a company must have disclosed in its most recent annual report that it intends to disclose these events on its website and provide its website address.
 - b. Website dissemination would be subject to the same five-business day deadline.
 - c. The website disclosure must be maintained for at least 12 months. Following the 12-month period, the company must retain the information for a period of not less than five years.
9. Because they are not subject to specific interim or current disclosure requirements by the SEC, foreign private issuers do not have to provide immediate disclosure of any change to, or waiver of, the company's code of ethics. Instead, they must disclose any such change that has occurred during the past fiscal year in their Exchange Act annual report. Although not required, a foreign private issuer may make these disclosures on a Form 6-K or its Internet website.
10. New Item 406(b) of Regulations S-K and S-B defines the term "code of ethics" as written standards that are reasonably designed to deter wrongdoing and to promote:
 - a. Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
 - b. Full, fair, accurate, timely and understandable disclosure in reports and documents that a registrant files with, or submits to, the Commission and in other public communications made by the registrant;
 - c. Compliance with applicable governmental laws, rules and regulations;
 - d. The prompt internal reporting to an appropriate person or persons identified in the code of violations of the code; and
 - e. Accountability for adherence to the code.
11. Specific language for the code of ethics is not included in the new rules as the SEC believes that ethics codes do, and should, vary from company to company and that decisions as to the specific provisions of the code, compliance procedures and disciplinary measures for ethical breaches are best left to the company. The SEC stated in the adopting release that it encourages companies to adopt codes that are broader and more comprehensive than necessary to meet the new disclosure requirements.
12. Companies may have separate codes of ethics for different types of officers. If the code of ethics covers more topics than reflected in the SEC's definition or it covers more persons than the principal executive and senior financial officers, a company needs only to file, post, or provide the portions that relate to the topics and people covered by the rules.

13. Companies, including small business issuers, must comply with the code of ethics disclosure requirements in their annual reports for fiscal years ending on or after July 15, 2003. Any amendments to, or waivers of, a company's code of ethics must be disclosed on or after the date on which they file that annual report.

14. SEC Rule – Disclosure Required by Section 407 of the Sarbanes-Oxley Act of 2002 (Audit Committee Financial Expert) (Release No. 33-8177 and No. 33-8177A)

1. Section 407 of the Act requires the SEC to adopt rules requiring a company to disclose whether its audit committee includes at least one member who is a financial expert and to define the term “financial expert.”
2. To more appropriately capture the attributes referenced in Section 407 of the Act, the SEC decided to use the term “audit committee financial expert” rather than “financial expert.” The SEC believes this term suggests more pointedly that the designated person has characteristics that are particularly relevant to the functions of the audit committee.
3. The new disclosure requirements apply to domestic issuers, including small business issuers, and are contained in Item 401 of Regulations S-K and S-B, “Directors, Executive Officers, Promoters and Control Persons.” Companion rules applying to foreign private issuers have been added to Forms 20-F and 40-F. The rules do not apply to registered investment companies. (The SEC adopted similar rules for investment companies. Those new rules are contained in Release 34-47262.)
4. Companies will be required to include the new financial expert disclosures in their annual reports on Forms 10-K, 10-KSB, 20-F or 40-F. (In Release No. 33-8177A, the SEC confirmed that this disclosure is not required in other filings (e.g., registration statements).) Domestic companies must include the disclosures in Part III of Forms 10-K or 10-KSB. Consequently, the company could incorporate this information by reference from its definitive proxy or information statement that involves an election of directors.
5. The final rules require that a company disclose the following with respect to an audit committee financial expert in its annual report:
 - a. Whether or not the company has at least one audit committee financial expert serving on its audit committee;
 - b. The name of at least one person that the board of directors has determined to be an audit committee financial expert;
 - c. If a domestic company discloses that it has at least one audit committee financial expert, whether that expert is “independent,” as that term is used in Item 7(d)(3)(iv) of Schedule 14A, and if not, an explanation of why he or she is not; and
 - d. If the company does not have a financial expert serving on the audit committee, it must disclose that fact and explain why it has no financial expert.
6. The rules in this release did not require a foreign private issuer to comment on an audit committee financial expert's independence. As discussed in section 3, the Commission subsequently adopted rules (which are contained in Release No. 33-8220) that require a foreign private issuer to evaluate and disclose whether its audit committee financial expert is independent using the same standards as a domestic issuer.
7. The final rules permit, but do not require, a company to disclose that it has more than one audit committee financial expert. If the company discloses that more than one person is designated as an audit committee financial expert, only one of the experts is required to be identified by name.

8. The definition of “audit committee financial expert” is less restrictive than what was proposed. The final rules define the term “audit committee financial expert” as a person who has all of the following attributes:
 - a. An understanding of GAAP and financial statements (with respect to foreign private issuers, the audit committee financial expert’s understanding must be of the generally accepted accounting principles used by the foreign private issuer in preparing its primary financial statements);
 - b. The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
 - c. Experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and level of complexity of issues that can reasonably be expected to be raised by the registrant’s financial statements, or experience actively supervising one or more persons engaged in such activities;
 - d. An understanding of internal controls and procedures for financial reporting; and
 - e. An understanding of audit committee functions.
9. Under the rules, a person must have acquired such attributes through any one or more of the following:
 - a. Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor, or experience in one or more positions that involve the performance of similar functions;
 - b. Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant or auditor or person performing similar functions;
 - c. Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
 - d. Other relevant experience.
10. The attributes listed above are broader than the SEC had proposed. (Italicized words below represent changes from the proposed rules that are reflected in the final rules.)
 - a. The second attribute requires the *ability to assess* the application of GAAP in accounting for estimates, accruals, and reserves. The proposed rules would have instead required a person to have experience applying such GAAP to items that are generally comparable to those in the registrant’s financial statements. The proposed definition might have limited the pool of people who would qualify to those within a registrant’s industry.
 - b. The third attribute requires experience preparing, auditing, *analyzing or evaluating* financial statements *or experience actively supervising one or more persons engaged in such activities*. The final rules recognize that persons such as investment bankers, venture capitalists, and financial analysts may have experience working directly and closely with financial statements in a way that provides familiarity with the contents of financial statements and the processes behind them. They also recognize that persons who actively supervise others may also possess the requisite experience if the persons they supervise engage in the activities referred to above and the supervisor participates in and contributes to the process of addressing the same general types of issues as those addressed by the persons they supervise.
 - c. The third attribute requires experience with financial statements that present a *breadth and level of complexity* of accounting issues that are generally comparable to those *expected to be* raised by the registrant’s financial statements. The SEC clarified that it does not require the person to have experience in the same industry as the registrant or experience with a public company.
 - d. The fourth attribute requires an *understanding of* internal controls. The proposed rules would have instead required experience with internal controls. The final rules reflect the SEC’s belief that if a

- person understands the purpose and is able to evaluate the effectiveness of a company's internal controls, experience in doing so is not necessary.
11. The permitted means of obtaining these attributes are more flexible than had been proposed.
 - a. The SEC eliminated a proposed requirement for a person to have gained the attributes through experience with a public company.
 - b. The Commission added a provision indicating that experience overseeing or assessing the performance of companies or public accountants would provide the required attributes. This provision recognizes that certain people who work for governmental, self-regulatory, and other bodies that oversee the banking, insurance and securities industries work on financial statement issues on a regular basis and can have a useful background for an audit committee financial expert.
 - c. The provision acknowledging that a person may acquire the necessary attributes through other relevant experience is similar to a provision in the proposed rules. However, the proposed rules would have required a company to disclose the board's basis for determining that a person has "similar expertise and experience." The final rules do not require such disclosure. Instead, if "other relevant experience" is the basis for the person's financial expertise, a company must briefly list the person's experience. The company may provide this disclosure by referring to other disclosures relating to the director's business experience in the annual report. (Regulations S-K and S-B and Form 20-F already require such disclosures.)
 12. Neither previously serving on an audit committee nor experience as a public accountant or auditor, or a principal financial officer, controller, or principal accounting officer would, by itself, justify the board of directors in determining that a person is an audit committee financial expert.
 13. A safe harbor has been added to make it clear that an audit committee financial expert is not deemed an "expert" under Section 11 of the Securities Act or for any other purpose. In addition, an audit committee financial expert has no greater obligations or liability than the members of the audit committee and board of directors who are not designated as financial experts, and the presence of an audit committee financial expert does not reduce the other members' obligations or liability.
 14. Companies, other than small business issuers, must comply with the audit committee financial expert disclosures in their annual reports for fiscal years ending on or after July 15, 2003. Small business issuers must comply with the requirements in their annual reports for fiscal years ending on or after December 15, 2003.

Interpretations and Implementation Considerations

- a. *With regard to disclosures about whether an audit committee financial expert is independent, the evaluation must be made using the independence standards of the exchange on which the issuer's securities are listed. (If the company is not a listed issuer, it must make the evaluation using the independence standards of an exchange of its choice.) The New York Stock Exchange and the NASDAQ have proposed changes to their rules to provide more demanding independence standards for audit committee members. Companies planning to add audit committee financial experts to their audit committees should consider these impending changes when evaluating candidates.*
- b. *The new rules regarding standards of professional conduct for attorneys discussed elsewhere provide companies with the option of establishing a qualified legal compliance committee (QLCC) to review potential violations of law and breaches of fiduciary duty. At least one of the members of a QLCC must be a member of the audit committee, and the audit committee may serve as the QLCC. Companies planning to change the composition of their audit committees should also consider whether they intend to establish a QLCC and whether they intend for the*

audit committee to serve as the QLCC. If so, a candidate's abilities to serve in that role should also be considered.

15. SEC Rule – Retention of Records Relevant to Audits and Reviews (Release No. 33-8180)

1. In this rule, the SEC implemented the requirements of Section 802 of the Act. Section 802 requires the SEC to adopt rules requiring accounting firms to retain certain records relevant to their audits and reviews of companies' financial statements.
2. The rules were adopted by creating Rule 2-06 of Regulation S-X.
3. The rules apply equally to domestic and foreign accounting firms. Compliance is required October 31, 2003.
4. Under new Rule 2-06(a), an auditor must retain records relevant to the audit or review, including:
 - a. Workpapers and other documents that form the basis of the audit or review of the issuer's financial statements; and
 - b. Memoranda, correspondence, communications, other documents and records (including electronic records) that meet the following two criteria:
 - Are created, sent or received in connection with the audit or review; and
 - Contain conclusions, opinions, analyses or financial data related to the audit or review.
5. The term "workpapers" is understood by the SEC to refer to the documents required to be retained by GAAS. However, the Public Company Accounting Oversight Board has the authority, subject to SEC oversight, to amend GAAS or to adopt new standards. The rule recognizes this fact and has defined the term in Rule 2-06(b) as "documentation of auditing or review procedures applied, evidence obtained, and conclusions reached by the accountant in the audit or review engagement, as required by standards established or adopted by the Commission or Public Company Accounting Oversight Board."
6. Memoranda, correspondence, communications, other documents and records (including electronic records) that meet the two criteria described above must be retained whether they support the auditor's final conclusions or contain information or data, relating to a significant matter, that is inconsistent with the auditor's final conclusions.
7. Such documentation includes, but is not limited to, those documenting a consultation on or resolution of differences in professional judgment.
8. The proposed rules would have required a retention period of five years after the end of the fiscal period audited or reviewed. The final rules will require a longer retention period of seven years to be consistent with the retention requirements in Section 103 of the Act for audit workpapers.

16. SEC Rule – Acceleration of Periodic Filing Dates and Disclosure Concerning Website Access to Reports (Release No. 33-8128)

1. Final rule adopted on August 27, 2002.
2. After a three-year transition (with no change for the first year), Form 10-K is required to be filed within 60 days of year-end and Form 10-Q within 35 days of quarter-end (currently 90 days and 45 days, respectively).
3. Applies only to companies with public float in excess of \$75 million. Small business issuers that file on Forms 10-KSB and 10-QSB and foreign private issuers are exempt.
4. A company's first accelerated filing will be its Form 10-K for its first fiscal year ending on or after December 15, 2003. Then the company will begin filing Form 10-Qs on an accelerated basis.

5. Accelerated filing will be phased in as follows (for a calendar year company):

Form 10-K

- For the year ended 12/31/02, were due 90 days after year-end (no change)
- For the year ending 12/31/03, will be due 75 days after year-end
- Thereafter, will be due 60 days after year-end

Form 10-Q

- For the three quarters in calendar 2003, will be due 45 days after quarter-end (no change)
- For the three quarters in calendar 2004, will be due 40 days after quarter-end
- Thereafter, will be due 35 days after quarter-end

6. An accelerated filer is required to disclose in its Form 10-K, beginning with reports for fiscal years ending on or after December 15, 2002, whether the company makes periodic and current reports (10-K, 10-Q and 8-K) available, free of charge, on or through its website on the same day as those reports are filed with the SEC. If the company does not provide website access, it will be required to disclose why it does not do so.

17. SEC Proposed Rule – Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date (Release No. 33-8106)

1. Proposal to add an additional 11 items which would require Form 8-K filing – most of which deal with unusual, material transactions not in the ordinary course of business, including:
 - a. New material agreement
 - b. Termination of material agreement
 - c. Termination of a significant customer relationship
 - d. Exit activities (write-offs and restructurings)
 - e. Impairments
 - f. Rating agency downgrade
2. Require Form 8-K disclosure for unregistered sales of equity securities and material modifications of shareholders' rights (currently these matters are required Form 10-Q/10-K disclosures).
3. Foregoing items would be required to be disclosed within 2 business days of occurrence. The proposal would also accelerate the timing for other Form 8-K disclosures from 5 business or 15 calendar days to 2 business days.
4. Proposed in June 2002. Comment period on the proposed rules closed in August 2002.

18. SEC Proposed Rule – Disclosure in Management's Discussion and Analysis about the Application of Critical Accounting Policies (Release No. 33-8098)

1. Proposal to require a separately captioned section in MD&A regarding the critical accounting estimates made by companies in applying accounting policies and initial adoption of certain accounting policies.
2. The proposal builds on the disclosures the SEC encouraged registrants to make in Financial FR-60, "Cautionary Advice Regarding Disclosure About Critical Accounting Policies," issued in December 2001. According to the SEC staff, most companies fell short of the type of thoughtful discussions contemplated by the SEC.
3. Critical accounting estimates – An accounting estimate is considered "critical" if:

- a. It requires the company to make assumptions about matters that are highly uncertain at the time it is made; and
- b. Different estimates that the company reasonably could have used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, would have a material impact on the company's financial statements.
4. Examples of critical accounting estimates include:
 - a. Inventory reserves;
 - b. Impairment of assets; and
 - c. Tax and litigation issues. (This is unclear. Such disclosures could provide a roadmap, which would place the company at a disadvantage.)
5. The following disclosures about critical accounting estimates would be required:
 - a. A discussion that identifies and describes the estimate, the methodology used, certain assumptions and reasonably likely changes;
 - b. An explanation of the significance of the estimate to the company's financial statements and identification of the line items in the company's financial statements affected by the estimate;
 - c. A *quantitative* discussion of changes in the overall financial performance and line items in the financial statements if the company were to assume that the estimate was changed, either by:
 - Using reasonably possible near-term changes in certain assumptions or
 - The reasonably possible range of the estimate;
 - d. A quantitative and qualitative discussion of any material changes made to the estimate in the past three years, the reasons for the changes, and the effect on line items in the financial statements and overall financial performance;
 - e. A statement of whether or not the company's senior management has discussed the development and selection of the estimate, and the MD&A disclosure regarding it, with the company's audit committee; and
 - f. A discussion of the estimate on a segment basis.
6. Initial adoption of accounting policies
 - a. The rules would require disclosure if an accounting policy was adopted (other than one resulting from the mandated adoption of new accounting literature) and it had a material impact on the company's financial statements.
 - b. Required disclosures would include:
 - If the company was permitted a choice among acceptable accounting principles, what the alternatives were, and why the company made the choice it did, including qualitative disclosure of the impact on the company's financial presentation that the alternatives would have had.
 - If no accounting literature exists addressing the events or transactions giving rise to the initial adoption, an explanation of the company's decision as to which accounting principle to use.
7. Although not included in the proposal, the SEC is also considering whether to require the new MD&A disclosures relating to critical accounting estimates to be examined by an independent auditor.
8. Proposed in May 2002. Comment period on the proposed rules closed in July 2002.