

**SEC ADOPTS FINAL RULES REGARDING
MANAGEMENT'S REPORTS ON INTERNAL CONTROL
OVER FINANCIAL REPORTING AND
CERTIFICATION OF DISCLOSURE IN PERIODIC REPORTS**

June 27, 2003

Section 404 of the Sarbanes-Oxley Act of 2002 (the "Act") directs the Securities and Exchange Commission (the "SEC") to adopt rules requiring issuers¹ to include in their annual reports an internal control report (1) stating management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting and (2) containing an assessment, as of the end of the issuer's most recent fiscal year, of the effectiveness of the issuer's internal control structure and procedures for financial reporting. Section 404 also requires every registered public accounting firm that prepares or issues an audit report on a company's annual financial statements to attest to, and report on, the assessment made by management. Earlier this month, the SEC adopted rules to implement Section 404.² In the same release, the SEC also adopted amendments to its rules and forms to revise the periodic report certification requirements under Sections 302 and 906 of the Act.

The new rules under Section 404 of the Act are effective for the fiscal year ending on or after June 15, 2004 for accelerated filers³ and for the fiscal year ending on or after April 15, 2005 for other issuers. The amendments to the Section 302 and 906 certifications become effective August 17, 2003.

¹ Under the Act, an "issuer" (as defined in Section 3(a)(8) of the Securities Exchange Act of 1934, as amended (the "Exchange Act")) is subject to the Act if (1) the issuer's securities are registered under Section 12 of the Exchange Act, (2) the issuer is required to file reports under Section 15(d) of the Exchange Act, or (3) the issuer files or has filed a registration statement that has not yet become effective under the Securities Act of 1933, as amended (the "Securities Act"), and that has not been withdrawn.

² Final Rule: Management's Reports on Internal Control Over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports, Release No. 33-8238 (June 5, 2003) (available at <http://www.sec.gov/rules/final/33-8238.htm>).

³ An accelerated filer is a company that meets the following conditions as of the end of its fiscal year: (1) its common equity public float was \$75,000,000 or more as of the last business day of its most recently completed second fiscal quarter; (2) it has been subject to the reporting requirements of Section 13(a) or 15(d) of the Exchange Act for at least 12 months preceding the filing of the report; (3) it has filed at least one annual report pursuant to Section 13(a) or 15(d) of the Exchange Act; and (4) it is not be eligible to use Forms 10-KSB and 10-QSB.

I. Final Rules Implementing Section 404

Differences Between Proposed and Final Rules

Although the final rules in many respects mirror the SEC proposals issued October 22, 2002,⁴ the final rules include the following modifications to the proposed rules:

- The SEC has chosen to use the term “internal control over financial reporting,” instead of the proposed term “internal control and procedures for financial reporting.” In addition, the SEC abandoned the proposed definition of the term, which was based on the Codification of Statements of Auditing Standards Section 319, and adopted a broader definition based on the Internal Control - Integrated Framework published by the Committee of Sponsoring Organizations of the Treadway Commission (the “COSO Framework”).
- Issuers will not be required to provide the proposed quarterly evaluations of internal control over financial reporting. Instead, in quarterly reports, issuers will only be required to provide disclosure regarding material changes to the company’s internal control over financial reporting.
- The effective dates have been delayed to allow more time for compliance, and issuers that are not accelerated filers have been given even more time to comply with the new rules.

Definition of “Internal Control Over Financial Reporting”

The Section 404 report prepared by management (and attested by the outside auditors) must assess the issuer’s “internal control over financial reporting.” The SEC has defined this term to mean 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 (“GAAP”). This process includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures of the issuer are being made only in accordance with the authorizations of management and directors of the issuer; and

⁴ Proposed Rule: Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, Release No. 33-8138 (October 22, 2002) (available at <http://www.sec.gov/rules/proposed/33-8138.htm>).

- 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.

Management's Annual Assessment and Report

The final rules add a new Item 308 to Regulations S-K and S-B to require an issuer to include in its annual report an internal control report of management that contains:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company;
- A statement identifying the framework used by management to conduct the required evaluation of the effectiveness of the company's internal control over financial reporting;
- 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.⁵ The assessment must include disclosure of any material weaknesses⁶ in the company's internal control over financial reporting identified by management. 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 in the company's internal control over financial reporting; and
- A statement that the registered public accounting firm that audited the financial statements included in the annual report has issued an attestation report on management's assessment of the issuer's internal control over financial reporting.

Evaluation Framework. An issuer's management must base its evaluation of the effectiveness of the company's internal control over financial reporting on a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment.⁷ The SEC stated that a suitable framework must be free from bias, permit reasonably consistent qualitative and quantitative measurements of a company's internal control, be sufficiently complete so that

⁵ The SEC indicated that 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.

⁶ As defined in Statement on Accounting Standards No. 60, a "material weakness" is a reportable condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements caused by errors or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

⁷ While the SEC is not mandating a particular framework, the SEC indicated that the COSO Framework satisfies the requirements of the rule. An executive summary of the COSO Framework can be accessed at www.coso.org, and the full text can be obtained from www.aicpa.org.

those relevant factors that would alter a conclusion about the effectiveness of a company's internal control are not omitted and be relevant to an evaluation of internal control over financial reporting.

Auditor Involvement. Because the auditor must attest to management's assessment of internal control over financial reporting, management and the company's independent auditors must coordinate their processes of documenting and testing the internal control over financial reporting. However, under the auditor independence rules, management cannot delegate its assessment responsibility to the independent auditors.

Method of Evaluating. The assessment of a company's internal control over financial reporting must be based on procedures sufficient both to evaluate its design and to test its operating effectiveness. Among the controls that must be assessed are: controls over initiating, recording, processing and reconciling account balances, classes of transactions and disclosure and related assertions included in the financial statements; controls related to the initiation and processing of non-routine and non-systematic transactions; controls related to the selection and application of appropriate accounting policies; and controls related to the prevention, identification and detection of fraud.

The assessment must be supported by "evidential matter," including documentation, regarding both the design of internal controls and the testing processes. The evidential matter should provide reasonable support for the evaluation of whether the control is designed to prevent or detect material misstatements or omissions; for the conclusion that the tests were appropriately planned and performed; and for the conclusion that the results of the tests were appropriately considered.

Quarterly Evaluation. The SEC originally proposed to require management to evaluate the effectiveness of the company's internal controls as of the end of the period covered by each annual and quarterly report. In the final rules, however, the SEC is only requiring issuers to evaluate any change in the company's internal control over financial reporting that occurred during a fiscal quarter and has materially affected, or is likely to materially affect, the company's internal control over financial reporting.

Location of Management's Report. The final rules do not specify where management's internal control report must appear in the company's annual report, but the SEC has indicated that the management report should be in close proximity to the corresponding attestation report issued by the company's registered public accounting firm. The SEC anticipates that most companies will place the reports near MD&A or in a portion of the document immediately preceding the financial statements.

Distinguishing Disclosure Controls and Procedures

In its release, the SEC attempted to clarify the distinction between "internal control over financial reporting" and "disclosure controls and procedures". Disclosure controls and procedures are procedures designed to ensure that information required to be disclosed is captured and reported in a timely fashion. Although the SEC acknowledges that there is substantial overlap between the two and some components of internal control over financial

reporting will be included in disclosure controls and procedures, the SEC believes that, in most cases, disclosure controls and procedures will not include all components of internal control.

Changes to Quarterly Disclosure Under Item 307 of Regulations S-K and S-B

Item 307 of Regulations S-K and S-B, as adopted in August 2002 in response to Section 302 of the Act, required each issuer, in its quarterly and annual reports, to disclose the conclusions of the issuer's principal executive and financial officers (or persons performing similar functions) about the effectiveness of the company's disclosure controls and procedures as of a date within 90 days of the filing of the quarterly or annual report. Item 307(b) required the issuer to disclose in each quarterly and annual report whether or not there were significant changes in the company's internal controls or other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

The SEC is now amending Item 307 to require that the issuer's principal executive and financial officers review the company's disclosure controls and procedures as of the end of the period covered by the quarterly or annual report, rather than as of a date within 90 days of the filing date of such report. In addition, as noted above, new Item 308 requires an issuer to disclose any material change in its internal control over financial reporting that occurred during the fiscal quarter covered by the quarterly or annual report. As a result, Item 307(b), relating to the evaluation of changes in internal controls, has been removed.

Accountants' Attestation

As required by Section 404(b) of the Act, Rule 2-02 of Regulation S-X requires every registered public accounting firm that issues an audit report on the company's financial statements that are included in its annual report containing a management assessment of internal control over financial reporting to attest to, and report on, such management assessment. Under Section 404(b) of the Act, the Public Company Accounting Oversight Board (the "Oversight Board") is required to set standards for such attestations. In response, the Oversight Board recently designated Statements on Standards for Attestation Engagements ("SSAE No. 10") as the standard for attestation of management's assessment of internal control over financial reporting pending further Oversight Board standard-setting in the area (and SEC approval of the Oversight Board's actions). The SEC has approved SSAE No. 10 as the standard applicable on a transition basis for attestations under Section 404 of the Act.

Effective Dates for Compliance

In response to comments requesting an extended transition period for compliance with the new disclosure requirements, the SEC has decided to delay the compliance date for the new Section 404 disclosure and attestation requirements. A company that is an accelerated filer, as of the end of its first fiscal year ending on or after June 15, 2004, must comply with the new disclosure requirements in its annual report for that fiscal year. Companies that are not accelerated filers must begin to comply with the disclosure requirements in annual reports for their first fiscal year ending on or after April 15, 2005. A company must begin to comply with the requirement to provide a quarterly evaluation of changes to internal control over financial

reporting in its first periodic report due after the first annual report that must include the management's report and auditor attestation. The rules amending the requirements under Item 307 of Regulations S-K and S-B are effective August 17, 2003.

Issuers Affected

Small Business Issuers. The rules implementing Section 404 of the Act do not distinguish between large and small issuers. However, due to concerns that many small business issuers may experience difficulty in evaluating their internal control over financial reporting, the SEC provided an extended compliance period for the new disclosure requirements, as discussed above.

Bank and Thrift Holding Companies. Section 404 of the Act does not contain an exemption for insured depository institutions that are both subject to the internal control report requirements of the Federal Deposit Insurance Corporation ("FDIC") and required to file annual reports under the Exchange Act. Nonetheless, the SEC and FDIC have determined that insured depository institutions may choose one of the following disclosure options: (1) they can prepare two separate management reports to satisfy the FDIC's and SEC's requirements; or (2) they can prepare a single management report that satisfies both the FDIC's requirements and the SEC's requirements.⁸

II. Amendments to Sections 302 and 906 Certifications

Section 302 Certifications

The SEC has amended the exhibit requirements of Item 601 of Regulations S-K and S-B to add the Section 302 certification as a required exhibit under Item 31. As a result, the certification will no longer appear on the signature page of the annual or quarterly report, but will instead be a required exhibit.

In addition, the SEC has adopted several amendments to the form of the Section 302 certification to conform to the new rules under Section 404. The text of the new certification is attached to this memorandum as Exhibit A.

Section 906 Certifications

The Section 906 certification has also been added to Item 601 of Regulations S-K and S-B, as an Item 32 exhibit. Unlike the Section 302 certification, the Section 906 certification will be considered "furnished," rather than "filed" with the SEC. Thus, the Section 906 certification will not be subject to liability under Section 18 of the Exchange Act, nor will it be subject to automatic incorporation by reference into a company's registration statements filed under the Securities Act.

The SEC also discussed the statement regarding Section 906 certifications introduced into the Congressional Record by Senator Joseph Biden on April 11, 2003. The statement asserts that the Section 906 certification is intended to apply to current reports on Form 8-K and annual

⁸ The release contains a checklist of items that must be contained in the combined report if this option is selected.

reports of certain benefit plans on Form 11-K, in addition to periodic reports on Forms 10-Q and 10-K. The SEC is concerned about extending Section 906 in this manner and is currently considering the issue in consultation with the Department of Justice.

Distinctions Between Sections 302 and 906 Certifications

Unlike the Section 302 certifications, the Section 906 certifications are required only in periodic reports that contain financial statements. As a result, amendments to periodic reports that do not contain financial statements would not require a new Section 906 certification. However, amendments do need to include a new Section 302 certification. In addition, unlike the Section 302 certification, the Section 906 certification may take the form of a single statement signed by a company's chief executive officer and chief financial officer.

Effective Dates for Compliance

The final rules regarding filing of certifications under Sections 302 and 906 will be effective August 17, 2003. However, two statements in the Section 302 certification are not required to appear until the effective date of the Section 404 rules discussed above. These two provisions have been bracketed and marked with an asterisk in the form of certification attached as Exhibit A to this memorandum.

III. Practical Considerations

Even though the new rules under Section 404 have a delayed effective date, issuers must begin to prepare for compliance right away. Implementing an internal control structure is a complex undertaking that will involve many participants within a company. Companies should consider the following practical pointers:

- Analyze the company's existing internal control over financial reporting. Understand the differences between three categories of controls: (1) internal controls the company already has; (2) existing controls that will be altered or enhanced; and (3) new internal controls to be established.
- Obtain a copy of the COSO Framework. The SEC has endorsed this framework, and many financial institutions have been using it to comply with their FDIC internal control disclosure requirements since 1993.
- Coordinate with the company's outside auditor regarding the scope of the new rules. While the outside auditor cannot be solely responsible for designing or implementing the company's Section 404 systems, it can evaluate, review, recommend and assist with internal control reporting requirements. Since the auditor is going to attest to management's assessment, it is better for the company to know sooner rather than later what the auditor's views are.
- Coordinate the company's efforts to implement Section 404 with the company's existing disclosure controls and procedures in the disclosure committee. Gain a clear understanding of the relationship between internal control over financial reporting and disclosure controls and procedures.

If you have any questions about the new rules and amendments discussed in this memorandum or if we can be of further assistance, please contact the Womble Carlyle attorney with whom you work or any one of the lawyers listed below.

Garza Baldwin, III	(704) 331-4907	Jane Jeffries Jones	(704) 331-4953
Glenn A. Brown	(404) 962-7515	G. William Joyner III	(336) 721-3579
Meredith P. Burbank	(404) 888-7455	Alonzo L. Llorens	(404) 888-7353
Elizabeth O. Derrick	(404) 888-7433 or (864) 255-5415	Keith J. Mendelson	(703) 394-2246
Jeffrey C. Howland	(336) 721-3516	Douglas H. Shaver	(336) 721-3564
Lisa M. Hudson	(703) 394-2241	Kenneth N. Shelton	(919) 484-2319

This memorandum is a summary for general information only. It is not a full analysis of the matters presented and may not be relied upon as legal advice.

Text of Revised Section 302 Certification

I, [identify the certifying individual], certify that:

1. I have reviewed this [specify report] of [identify registrant];
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary 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;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) [and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f))* for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - [(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;]*
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: _____

[Name]

[Title]

* The bracketed language is not required to appear in the certification until the first annual report required to contain management's internal control report.