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Final Rules on Internal Control Reporting and Officer Certifications

The Securities and Exchange Commission has released final rules governing management's report on internal control over financial reporting and revisions to certification of disclosure in Exchange Act periodic reports.¹ The rules implement the requirements of Section 404 of the Sarbanes-Oxley Act of 2002 and amend the officer certifications required by Sections 302 and 906. The final rules delay the originally proposed effective date for filing management's report on internal control over financial reporting. We believe many issuers will need the additional time to effectively document, evaluate, and test internal control over financial reporting.

EFFECTIVE DATE FOR CERTIFICATIONS

The rules pertaining to Section 302 and Section 906 certifications, including changes relative to registered investment companies, become effective on August 14, 2003 (the due date for June 30, 2003 quarterly filings). As discussed below, the Commission staff has indicated to us their intent to apply the revised Section 302 certification to all quarterly filings for the quarter ended June 30, 2003, regardless of the date actually filed. Section 302 certifications may temporarily omit certain references to internal control over financial reporting until the compliance date for management's report on internal control over financial reporting.

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

EFFECTIVE DATES FOR MANAGEMENT'S ASSESSMENT OF INTERNAL CONTROL OVER FINANCIAL REPORTING

Management's report on internal control over financial reporting will be required by issuers, other than foreign private issuers, that meet the definition of an "accelerated filer" in Exchange Act Rule 12b-2, for fiscal years ending on or after June 15, 2004 (December 31, 2004, for calendar-year accelerated filers). Accelerated filers are generally U.S. companies that have "public float"² over \$75 million and have filed an annual report with the Commission. Voluntary early compliance is permitted.

All other issuers, including small-business and foreign-private issuers, will be required to comply with the requirements of Section 404 for their fiscal years ending on or after April 15, 2005 (December 31, 2005, for calendar-year issuers). Voluntary early compliance is permitted.

The implementation date was delayed to provide issuers time to prepare for compliance with the requirements of Section 404 and to allow the Public Company Accounting Oversight Board to issue standards for the independent auditors' related attestation. Issuers should continue to prepare for the internal control evaluation required by Section 404 to ensure that management is well-positioned to conclude on whether the issuer's internal control over financial reporting is effective when the new rules come into force.

OFFICERS' CERTIFICATIONS

The final rules add the certifications required by Sections 302 and 906 of the Sarbanes-Oxley Act to the list of required exhibits to be included in periodic reports filed with the Commission.

The final rules permit issuers to "furnish" rather than "file" the Section 906 certifications. Thus, the Section 906 certifications will not be subject to liability under Section 18 of the Exchange Act. Nor will the certifications be subject to automatic incorporation by reference into an issuer's registration statements, and therefore subject to liability under Section 11 of the Securities Act, unless the issuer takes steps to include or incorporate the certifications in a registration statement.

The certification requirements pertaining to Section 302 have been revised. For all filers, other than registered investment companies, the certifications under Section 302 will include a statement that disclosure controls and procedures have been evaluated as of the end of the period covered by the quarterly or annual report. This modifies the previous requirement for an assessment of disclosure controls and procedures occurring within 90 days of filing the quarterly or annual report. Issuers are required to disclose any change in internal control over financial reporting that has a material effect, or is reasonably likely to have a material effect, on internal control over financial reporting. The certifications also now include a statement affirming that the proper disclosures have been made.

TRANSITION FOR REVISIONS TO SECTION 302 CERTIFICATION

The Commission staff has indicated to us that the revisions to the Section 302 certification, including disclosure of material changes in internal control over financial reporting, are effective for quarterly filings due on or after August 14, 2003. Accordingly, the revised Section 302 certifications would apply to all June 30, 2003 quarterly filings, regardless of the actual date of the filing.

Based on informal discussions with the Commission staff, we understand that the disclosure of material changes in internal control over financial reporting during the transition period is not subject to a separate evaluation of such changes. The Commission staff has expressed to us their view that the disclosure would most likely be identified in the required evaluation of disclosure controls and procedures or in the preparation of financial statements. The requirement to evaluate changes in internal control over financial reporting for disclosure, referred to in Item 308 of Regulation S-K, is subject to delayed implementation consistent with the provision for management's report on internal control over financial reporting.

Issuers should consult their legal advisors with respect to the proper form of Section 302 certification to be included in periodic filings between now and the date the final rules become fully effective.

(2) The aggregate market value of the voting and non-voting common equity held by non-affiliates.

Below is the form of the Section 302 certification that issuers that are operating companies will be required to file when the final rules are fully effective. Changes to the certification are italicized; items that may be omitted prior to the full effectiveness of the rules are underlined. References to the period covered (annual or quarterly) and item 6 of the original certification addressing disclosure of changes to internal controls subsequent to an evaluation have been removed.

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 this 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 other 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: _____

[Signature]

[Title]

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Issuers, other than registered investment companies and asset-backed issuers, will have to include in each annual report a management report on internal control over financial reporting that contains the following elements:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company;
- A statement identifying the framework (e.g., COSO) used by management to evaluate the effectiveness of internal control over financial reporting;

- Management's assessment of the effectiveness of internal control over financial reporting as of the end of the issuer's most recent fiscal year that includes a statement as to whether or not the issuer's internal control over financial reporting is effective; and

- A statement that the issuer's independent auditor has issued an attestation report on management's assessment of internal control over financial reporting.

Section 404 requires the issuer's independent auditor to report on management's assessment of the effectiveness of the issuer's internal control over financial reporting in accordance with

standards to be established by the Public Company Accounting Oversight Board. Developing these standards is one of the Board's priorities. A copy of the independent auditors' report is required to be included in the issuer's annual report.

In its report, management is required to state whether the issuer's internal control over financial reporting is operating effectively. In addition, management must disclose identified material weaknesses³ in internal control over financial reporting, and any material weakness will preclude reporting that the issuer's internal control over financial reporting is operating effectively.

The final rules do not specify the methodology to be followed or procedures to be performed to complete management's assessment of internal control over financial reporting. However, the adopting release does indicate that in conducting an evaluation and developing an assessment, management must obtain evidential matter to provide reasonable support for management's assessment, including documentation regarding both the design of internal control over financial reporting and tests of its operating effectiveness. The assessment must be based on both the design and the operating effectiveness of the controls. The types of tests will depend on each issuer's circumstances. The adopting release indicates a general discussion with those individuals involved in the control process will not suffice.

The framework on which management's evaluation is based must be a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment. The report of the Committee of Sponsoring Organizations of the Treadway Commission (COSO), titled *Internal Control—Integrated Framework*, contains the suitable criteria most commonly used in the United States. Indeed, the adopting release says that the COSO framework "satisfies our criteria and may be used as an evaluation framework."

The release does not specify where in the issuer's filing to locate the management report. We expect that management's report will be located close to the corresponding attestation report issued by the issuer's independent auditor.

DEFINITION OF INTERNAL CONTROL

The final rules contain the following definition of the term "internal control over financial reporting."

"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:

- (1) Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the issuer;
- (2) Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorizations of management and directors of the issuer; and
- (3) 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."

This definition clarifies that, for purposes of reporting that complies with Section 404, internal control over financial reporting includes safeguarding of assets. A substantial portion of internal control over financial reporting also is included in the "disclosure controls and procedures" referred to in the Section 302 certifications.

(3) A material weakness is defined as 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 error or fraud in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned duties.



AUDITORS' INDEPENDENCE

The adopting release makes clear that auditors may assist management in documenting internal control over financial reporting without impairing independence. However, management must be involved throughout the process, cannot delegate its responsibility to assess its internal control over financial reporting to the auditor, and must make all decisions. The final rules do not amend the independence requirements currently in effect.

REGISTERED INVESTMENT COMPANIES

Management's report on internal control over financial reporting does not apply to registered investment companies, which were exempted by Section 405 of the Act. The final rules nevertheless require registered investment companies to maintain internal control over financial reporting. The form of the certifications was modified to reflect this responsibility and to conform with most changes that were made for operating companies. However, registered investment companies are permitted to continue to perform the evaluation of disclosure controls and procedures within 90 days prior to the filing date of the report. This will effectively limit to four the number of evaluations required annually for a series or family of registered investment companies. Registered investment companies are also required to disclose in their Form N-CSR any changes in internal control over financial reporting that occurred during the most recent fiscal half-year that has materially affected, or is reasonably likely to materially affect, the investment company's internal control over financial reporting.

The revisions to the Section 302 certification relative to the certifying officers' responsibility for establishing and maintaining internal control over financial reporting are effective for fiscal years ending on or after June 15, 2004. Other changes to the Section 302 certification are effective August 14, 2003.

Issuers should not treat the descriptive and summary statements in this presentation as a substitute for the actual rules. They should refer to the text of the rules and consult their accounting and legal advisors. In particular, issuers should consult with legal advisors on the proper form of certifications included in periodic filings between now and the ultimate effective date of these rules.

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