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HRO Alert

The Sarbanes-Oxley Act of 2002

Final Rules:

SECTION 404 INTERNAL CONTROL OVER FINANCIAL REPORTING AND CHANGES TO SECTIONS 302 AND 906 CERTIFICATIONS

On June 5, 2003, the SEC released final rules requiring reporting companies to include in their annual reports a report of management relating to the company's internal control over financial reporting. The final rules also provide that the certifications required under Sections 302 and 906 of the Sarbanes-Oxley Act of 2002 (the "SO Act") must be included as exhibits to applicable periodic reports.

These rules, issued under the SO Act, finalize and, in some cases, revise the SEC's proposed rules relating to internal control over financial reporting which were released on October 22, 2002, and the proposed rules relating to filing of Section 302 and 906 certifications which were released on March 21, 2003.

This HRO Alert summarizes the main provisions of the final rules. Compliance with the final rules regarding management's report on internal control over financial reporting will be required for accelerated filers beginning with fiscal years ending on or after on or after **June 15, 2004**. All other companies will be required to comply for fiscal years ending on or after **April 15, 2005**. The final rules and form amendments concerning Section 302 and Section 906 certifications generally will become effective **August 14, 2003**. However, the later compliance dates apply to the new requirements regarding management's internal control report to be included in the certifications. The SEC encourages companies to voluntarily furnish their Section 906 certifications as exhibits prior to the compliance date.

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

BACKGROUND

The final rules relating to internal control over financial reporting, adopted pursuant to Section 404 of the SO Act, require reporting companies (other than registered investment companies) to include in their annual reports a report by management regarding internal control over financial reporting. Section 404 of the SO Act also requires that each registered public accounting firm that audits a public company must attest to, and report on, the assessment made by management.

DEFINITION OF "INTERNAL CONTROL OVER FINANCIAL REPORTING"

The final rules define "internal control over financial reporting" as a process designed by, or under the supervision of, the principal executive and principal financial officers, or persons performing similar functions, and effected by the board of directors, management and other personnel, to provide reasonable assurance as to the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP. Internal control over financial reporting includes those policies and procedures that:

- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and disposition of company assets;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements, and that receipts and expenditures are being made only in accordance with management and director authorizations; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of assets that could have a material effect on financial statements.

MANAGEMENT'S ANNUAL REPORT ON INTERNAL CONTROL

Under the final rules, a company's annual report must include a report by management on the company's internal control over financial reporting. Such report must include:

- a statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting;
- a statement identifying the framework used by management to conduct the required evaluation of the effectiveness of internal control over financial reporting;
- management's assessment of the effectiveness of the company's internal control over financial reporting, including whether or not the company's internal control over financial reporting is effective and, if necessary, disclosure of any material weaknesses in the company's internal control over financial reporting; and
- a statement that the company's auditor has issued an attestation report on management's assessment of internal control over financial reporting.

In the release accompanying the final rules, the SEC instructed that management must report whether the internal control is effective or not. The SEC warned that a negative assurance indicating that nothing has come to the attention of management to suggest that the company's internal control over financial reporting is not effective, will not be acceptable.

The final rules do not specify a location for management's internal control report. However, the SEC suggested that it should be in close proximity to the corresponding attestation report issued by the company's auditor. The SEC noted that many companies will likely choose to place the internal control report and the attestation report near the MD&A section or immediately preceding the financial statements.

Assessment Framework

The final rules do not establish formal guidelines that companies must use to evaluate the effectiveness of a company's internal control over financial reporting and the company is free to choose an appropriate framework. However, the evaluation must be based on a suitable, recognized control framework chosen by the company that is established by a body or group that has followed due process procedures, including public comment, in formulating such standards. The release accompanying the final rules provides that the assessment framework must:

- be free from bias;
- permit consistent qualitative and quantitative measurements of internal control;

- be sufficiently complete so that 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.

One example of a framework that the SEC indicated it would consider effective is that adopted by the Committee of Sponsoring Organizations of the Treadway Commission.

Controls Subject to Assessment

Under the final rules, controls subject to assessment include, but are not limited to:

- controls over initiating, recording, processing and reconciling account balances, classes of transactions and disclosure and related assertions included in 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 SEC noted that management need not personally conduct the necessary activities to evaluate the design and test the operating effectiveness of internal control, but such activities may be conducted by non-management personnel acting under the supervision of management.

Method of Assessment and Evidentiary Matter

The SEC recognized that methods of conducting evaluations of internal control over financial reporting will vary from company to company and so did not specify particular methods. However, in the release accompanying the final rules, the SEC noted that the assessment must be based on methods sufficient both to evaluate the design of the internal control over financial reporting and to test its operating effectiveness. While the method of evaluation may vary among companies, the SEC noted that, in developing an assessment of its internal control over financial reporting, a company must support its conclusions with evidentiary matter, including documentation as to both the design of internal control and the testing process. The evidence should provide reasonable support:

- for the evaluation of whether control is designed to prevent or detect material misstatements or omissions;
- for the conclusion that the tests were appropriately planned and performed; and
- that the results of the tests were appropriately considered.

The company's auditor also will require such evidentiary material to support the assessment of management in connection with the attestation report.

Material Weaknesses

The final rules require that management's assessment of the effectiveness of internal control over financial reporting disclose any material weakness in the design or operation of internal controls that could adversely affect a company's ability to record, process, summarize and report financial data consistent with the assertions of management in financial statements. The final rules specifically provide that if management identifies one or more material weaknesses in the internal control over financial reporting, it cannot conclude that the internal control is effective.

Attestation Report

The final rules require a company to include in its annual report a report prepared by the company's auditor attesting to management's evaluation of internal control over financial reporting. The attestation report is a report in which an auditor expresses an opinion, or states that an opinion cannot be expressed, concerning management's assessment of the effectiveness of a company's internal control over financial reporting. It should be noted that under Section 404, attestation cannot be the subject of a separate engagement of the auditor. Moreover, the SEC reminded companies that its rules on auditor independence prohibit auditors from providing certain non-audit services to their public company clients and that management cannot delegate its responsibility to assess the company's internal control over financial reporting to the auditor. For a discussion of the newly adopted auditor independence rules, see the HRO Alert on Final Rules: Auditor Independence dated February 14, 2003.

QUARTERLY EVALUATIONS OF MATERIAL CHANGES IN INTERNAL CONTROL

In response to commenters' concerns, the SEC elected not to require public companies to perform an assessment of their internal control over financial reporting on a quarterly basis. Instead, the final rules require that management disclose and evaluate any change in the company's internal control over financial reporting that occurred during a fiscal quarter only if that change has materially affected, or is likely to materially affect, the company's internal control over financial reporting.

EVALUATIONS OF DISCLOSURE CONTROLS AND PROCEDURES

In adopting the final rules relating to internal control over financial reporting, the SEC made one notable revision to its rules relating to disclosure controls and procedures. The final rules revise the date to which the principal executive or principal financial officer's evaluation of the company's disclosure controls and procedures must relate. Prior to the adoption of the final rules, a company was required to disclose in its quarterly and annual reports the conclusions of the company's principal executive or principal financial officer's as to the effectiveness of the company's disclosure controls and procedures *as of a date within 90 days of the filing of such report*. The final rules, however, amend this provision to require disclosure as to the effectiveness of the company's disclosure controls and procedures *as of the end of the period covered by such report*.

COMPANIES AFFECTED

The final rules relating to internal control over financial reporting are applicable to all public companies, including foreign private issuers and small business issuers, but are not applicable to registered management investment or asset-backed issuers.

CERTIFICATION OF DISCLOSURE IN EXCHANGE ACT PERIODIC REPORTS**BACKGROUND**

Section 302 of the SO Act requires that a separate certification for each principal executive and financial officer be included in each quarterly and annual report. Currently the Section 302 certifications must be included as part of the text of the filing, located beneath the signature. Certifications under Section 906 of the SO Act must accompany any periodic report that contains financial statements, but may take the form of a single statement signed by a company's chief executive and financial officers. Since the Section 906 certification requirement became effective, companies have chosen to provide the certification in a number of ways including as correspondence, in an exhibit or as part of the text of the filing. The final rules require that these certifications be included as exhibits.

EXHIBIT REQUIREMENTS

The final rules add Section 302 and 906 certifications to the list of required exhibits for periodic reports. Section 302 certifications will be required for annual reports filed on Forms 10-K, 10-KSB, 20-F, 40-F and quarterly reports filed on Forms 10-Q and 10-QSB. Section 906 certifications will be required for annual reports on Forms 10-K, 20-F, and 40-F and quarterly reports on Form 10-Q. The Section 302 and 906 certification requirements apply only to periodic reports, not current reports such as those on Forms 6-K and 8-K. The SEC and DOJ are currently considering whether 906 certifications should be extended to Forms 6-K, 8-K and 11-K, but the SEC is informally advising companies to include 906 certifications with their Forms 11-K.

Section 302

The new form and content of the Section 302 certification are now set forth in the applicable exhibit filing requirements for a company's periodic reports in Item 601 of Regulation S-K. The final rules amend the form of Section 302 certifications by providing as follows:

- That principal executive and financial officers are responsible for establishing and maintaining disclosure controls and procedures, and internal control over financial reporting;
- That disclosure controls and procedures may be designed under the supervision of principal executive and financial officers, rather than directly by those officers;
- That the principal executive and financial officers have evaluated the effectiveness of the disclosure controls and procedures and are presenting in the report their conclusions as of the end of the period covered by the report, rather than as of a date within 90 days prior to the filing date of the report; and
- That principal executive and financial officers have disclosed any change in internal control over financial reporting that occurred during the most recent fiscal quarter that materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

Section 906

Under the final rules, Section 906 certifications must be included as an exhibit to the report but need only be furnished to the Commission, not filed. This means that the certifications will not be subject to liability under Section 18 of the Securities Exchange Act of 1934. In addition, the certification will not be subject to automatic incorporation by reference into a company's registration statements filed pursuant to the Securities Act of 1933, which are subject to liability under Section 11, unless the issuer takes steps to incorporate the certifications into a registration statement. Also, because the certification will be furnished rather than filed, omission will not affect the company's Form S-3 eligibility.

Interim guidance, encouraging issuers to submit 906 certifications as exhibits, will remain in effect until the rules become effective. Until EDGAR permits registrants to file or furnish exhibits 31 and 32 for Section 302 and 906 certifications, companies should submit certifications as Exhibit 99. The SEC will issue a statement on the Commission's website as soon as EDGAR is updated. During the interim period issuers should insert the following legend after the text of each Section 906 certification:

"A signed original of this written statement required by Section 906, or other document authenticating, acknowledging, or otherwise adopting the signature that appears in typed form

within the electronic version of this written statement required by Section 906, has been provided to [name of issuer] and will be retained by [name of issuer] and furnished to the Securities and Exchange Commission or its staff upon request.”

HOW HRO CAN HELP

Compliance with the disclosure obligations of the final rules will require your company to maintain a framework to control information relevant to the public for both financial and non-financial information. If you would like to discuss the final rules and how they may affect your company, we encourage you to contact any of the persons listed on the first page of this HRO Alert.

This HRO Alert is a periodic publication of Holme Roberts & Owen LLP and should not be construed as legal advice or legal opinion on any specific facts or circumstances or all of the provisions included in the newly adopted rules. Nor is it intended to address specific disclosure or compliance issues that may arise in particular circumstances or all of the provisions included in the newly adopted rules. The contents are intended for general informational purposes only, and you are urged to consult counsel concerning your own situation and any specific legal questions you may have. For further information regarding the rules described herein, please contact any of the persons listed in the margin of the first page of this alert.

7/08/03

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