

The US Sarbanes-Oxley Act of 2002: What audit committees of non-US issuers need to know

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ABSTRACT

KEYWORDS: *audit committees, Sarbanes-Oxley Act, foreign private issuers, SEC registrants, non-US companies*

The US Sarbanes-Oxley Act of 2002 ('the Act') introduced sweeping changes in the regulation of issuers of public securities in the USA, including non-US issuers. Audit committees are a key area of corporate governance addressed by the Act, and the authors summarise how the Act applies to audit committees of non-US issuers. First, the Act imposes certain requirements directly on audit committees, relating to areas such as independence and substantive duties. Secondly, it indirectly sets standards for audit committees, for example, through regulation of auditors. Finally, the Act introduces a far-reaching concept, internal control over financial reporting. Audit committee members need to understand the internal control rules in detail, because of the critical importance of internal control to an issuer's financial reporting. The authors

conclude that the full weight of the Act will only be felt when the Act's 'internal control' provisions come into effect in 2005.

INTRODUCTION

When President George W. Bush signed the Sarbanes-Oxley Act of 2002 (the 'Sarbanes-Oxley Act', 'Sarbanes-Oxley', or the 'Act') into law, he called it 'the most far-reaching reforms of American business practice since the time of Franklin Delano Roosevelt'. Watching the passage of the Act was a bit like watching a child do a 'cannonball' dive into a small pool: it drenched a few onlookers and triggered a wave of rule-making by the Securities and Exchange Commission (SEC).

Foreign private issuers — a term that covers most non-US issuers, other than foreign governments — were among the most surprised (and in many cases unhappy) bystanders in this process. Unlike other recent SEC initiatives (such as Regulation FD), the Sarbanes-Oxley Act did not generally distinguish between US domestic and foreign private issuers.

Audit committees are a key area of corporate governance addressed by the Act. Sarbanes-Oxley applies to audit committees in three ways. First, it imposes certain

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requirements directly on audit committees, relating to areas such as independence and substantive duties. Secondly, it indirectly sets standards for audit committees, for example, through regulation of auditors. Finally, the Act introduces a far-reaching concept, internal control over financial reporting. Audit committee members need to understand the internal control rules in detail, because of the critical importance of internal control to an issuer's financial reporting.

This paper summarises the key provisions of the Act relevant to foreign private issuers. It also discusses briefly the related audit committee requirements under the revised corporate governance rules of the New York Stock Exchange (NYSE) and NASDAQ.

BACKGROUND: WHO IS SUBJECT TO SARBANES–OXLEY?

The Sarbanes–Oxley Act applies to all issuers — including foreign private issuers — that:

- have registered securities under the US Securities Exchange Act of 1934, as amended (the 'Exchange Act' or the '1934 Act');
- are required to file reports under Section 15(d) of the Exchange Act; or
- have filed a registration statement under the US Securities Act of 1933, as amended (the 'Securities Act' or the '1933 Act') that has not yet become effective.¹

This means, for example, that any foreign private issuer that has listed its securities in the USA, or issued securities to the public in the USA whether or not listed (such as in a registered exchange offer for high-yield bonds) is subject to the Sarbanes–Oxley Act. A foreign private issuer that has not sold securities to the public in the USA, or that is exempt from Exchange Act registration by virtue of Exchange Act Rule 12g3-2(b) is not subject to the requirements of the Sarbanes–Oxley Act. Accordingly, when the

authors refer below to 'issuers' and 'foreign private issuers' they mean those companies that are subject to Sarbanes–Oxley.

STANDARDS RELATING DIRECTLY TO AUDIT COMMITTEES

Listed company audit committees

The Sarbanes–Oxley Act charged the SEC with creating rules to prohibit the listing of any security in the USA of an issuer that is not in compliance with certain substantive standards for audit committees. The SEC has accordingly adopted Rule 10A-3 under the Exchange Act ('Rule 10A-3'). Listed foreign private issuers must be in compliance with Rule 10A-3 by 31st July, 2005.²

Under Rule 10A-3, audit committee members each have to be a member of the board of directors and be otherwise independent.³ To be 'independent', an audit committee member is barred from accepting any compensatory fees other than in that member's capacity as a member of the board⁴ and may not be an 'affiliated person' of the issuer.⁵ The definition of affiliated person includes a person who, directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with the specified person.⁶ There is, however, a safe harbour for certain non-executive officers and other persons who are 10 per cent or less shareholders of the issuer.⁷

Foreign private issuers are entitled to certain exemptions from the independence prong of Rule 10A-3. For example, the inclusion of a non-management employee representative,⁸ a non-management affiliated person with only observer status,⁹ or a non-management governmental representative on the audit committee will not violate the affiliated person prong of the independence test.¹⁰

Rule 10A-3 also requires that:

- the audit committee must be 'directly responsible' for the appointment, com-

pensation, oversight and retention of the external auditors, who must report directly to the audit committee;¹¹

- the audit committee must establish procedures for the receipt, retention and treatment of complaints regarding accounting, internal controls or auditing matters, and for the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters;¹²
- the audit committee must have the authority to engage independent counsel and other advisers as it deems necessary to carry out its duties;¹³ and
- the issuer must provide the audit committee with appropriate funding for payment of external auditors, advisers employed by the audit committee and ordinary administrative expenses of the audit committee.¹⁴

These requirements are not intended to conflict with local legal or listing provisions (or requirements under the foreign private issuer's organisational documents), and instead relate to the allocation of responsibility between the audit committee and the issuer's management.¹⁵ Accordingly, the audit committee may recommend or nominate the appointment or compensation of the external auditor to shareholders if these matters are within shareholder competence under local law,¹⁶ and it must be granted those responsibilities that the board of directors can legally delegate.¹⁷

Rule 10A-3 contains a general exemption for foreign private issuers that have a statutory board of auditors or statutory auditors established pursuant to home country law or listing requirements, which in turn meet various requirements.¹⁸

A foreign private issuer relying on Rule 10A-3's exemption from independence, or the general exemption noted above, will need to disclose in its annual report on Form 20-F filed with the SEC its reliance

on the exemptions and an assessment of whether this reliance will materially adversely affect the audit committee's ability to act independently and to satisfy any of the other requirements of Rule 10A-3.¹⁹

Audit committee financial expert

Under the Sarbanes-Oxley Act, the SEC has issued rules requiring a foreign private issuer to disclose in its annual report on Form 20-F that the issuer's board of directors has determined whether or not it has one audit committee financial expert serving on its audit committee, or if not, why not.²⁰ If the issuer has a two-tier board of directors, the supervisory or non-management board would make this determination.²¹ The issuer must also disclose the name of the audit committee financial expert (if any)²² and whether that person is 'independent' from management (note that for listed issuers the audit committee financial expert will need to satisfy the definition of 'independence' as set forth in Rule 10A-3).²³ An issuer's board of directors must make an affirmative determination whether or not it has at least one audit committee financial expert, and may not simply fail to reach a conclusion.²⁴

In order to qualify as an audit committee financial expert, the audit committee member must have the following 'attributes':²⁵

- an understanding of GAAP;
- the ability to assess the general application of GAAP in connection with the accounting for estimates, accruals and reserves;
- experience preparing, auditing or analysing financial statements similar to those of the issuer, or actively supervising others engaged in these activities;
- an understanding of internal controls and procedures for financial reporting; and
- an understanding of audit committee functions.

In addition, an audit committee financial expert must have gained those attributes through:²⁶

- education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor, or experience in similar positions;
- experience actively supervising these functions;
- experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
- other relevant experience.

The term ‘GAAP’ in this context refers to the body of generally accepted accounting principles used by the issuer in its primary financial statements.²⁷ Accordingly, the audit committee financial expert of a foreign private issuer need only be versed in local GAAP, and not in US GAAP or in reconciliation to US GAAP (although that experience would, of course, be useful).²⁸

The SEC’s rules contain a liability ‘safe harbour’ for the audit committee financial expert, under which:

- a person who is determined to be an audit committee financial expert is not deemed to be an ‘expert’ for any purpose, such as under Section 11 of the Securities Act; and²⁹
- the designation of a person as an audit committee financial expert does not impose greater duties, obligations or liabilities on the person than on other audit committee and board members, and does not affect the duties, obligations or liabilities of other audit committee and board members.³⁰

STANDARDS RELATING INDIRECTLY TO AUDIT COMMITTEES

Auditor independence

The Sarbanes–Oxley Act creates a series of requirements relating to the work of external auditors, grouped under the heading ‘auditor independence’. The SEC’s rules generally took effect on 6th May, 2003 (although many of the provisions of these rules have varying transition periods), and also apply to annual reports on Form 20-F in respect of fiscal years ending after 15th December, 2003.³¹

Under these rules, it is unlawful for an auditor not to be independent. Among other things, this means that the audit committee must pre-approve the engagement of the auditor to provide audit and non-audit services to the issuer or its subsidiaries, or must only engage the auditor pursuant to pre-approval policies and procedures established by the audit committee (subject to certain *de minimis* exceptions).³² An auditor must also report to the audit committee on (1) all critical accounting policies and practices to be used, (2) all alternative treatments of financial information within GAAP that have been discussed with the issuer’s management (as well as the implications of those alternatives and the auditor’s preferred treatment), and (3) all other material written communications between the auditors and management.³³

In addition, in its annual report on Form 20-F an issuer must disclose the pre-approval policies and procedures of its audit committee for audit and non-audit services.³⁴

Improper influence on the conduct of an auditor; communication with audit committee

The Sarbanes–Oxley Act directs the SEC to issue rules prohibiting any officer or director of an issuer from taking any action improperly to influence an auditor for the purpose of rendering the issuer’s financial statements

materially misleading. The SEC's implementing rules took effect on 27th June, 2003.³⁵ Among other things, the rules prohibit an officer or director of an issuer, or any other person acting under the direction of an officer or issuer, from taking any action to 'coerce, manipulate, mislead or fraudulently influence' an auditor engaged in the performance of an audit or review of financial statements of the issuer that are required to be filed with the SEC if that person knew or should have known that his or her actions, if successful, could result in rendering the issuer's financial statements materially misleading.³⁶

The rules identify certain types of actions which could cause an issuer's financial statements to be materially misleading. These include improperly influencing an auditor not to communicate matters to an issuer's audit committee.³⁷

An audit committee can find itself in a situation in which management and the auditors do not agree about the accounting treatment of a transaction (or series of transactions). In that case, audit committee members should be mindful of these prohibitions to avoid opening themselves to claims that the auditors were coerced into accepting an inappropriate result, which in turn had a material impact on the financial statements.

SECTION 404: INTERNAL CONTROL OVER FINANCIAL REPORTING

Background

Section 404 of Sarbanes–Oxley deals with internal control over financial reporting. It is one of the most far-reaching aspects of the Act, and is proving to be one of the most complicated to implement in practice.

Section 404 directs the SEC to issue rules requiring an issuer's annual report to contain an internal control report (1) stating management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial report-

ing 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. In addition, Section 404 requires an issuer's independent auditor to attest to, and report on, management's assessment, in accordance with standards adopted by the US Public Company Accounting Oversight Board (PCAOB). (Section 404 provides, however, that the attestation cannot be a separate engagement of the auditor.)

The SEC has accordingly adopted new implementing rules, and the PCAOB has adopted Auditing Standard No. 2.³⁸ Under the SEC's rules, a foreign private issuer must:

- maintain internal control over financial reporting;
- evaluate (with the participation of the CEO and CFO) the effectiveness of internal control as of the end of each fiscal year; and
- evaluate (with the participation of the CEO and CFO) any change in its internal control that occurred during the fiscal year that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.

In addition, a foreign private issuer's annual report on Form 20-F must contain an annual report from management on internal control, an attestation report of the issuer's independent auditor and disclosure of any changes in internal control. A foreign private issuer must comply with these rules in connection with its annual report on Form 20-F for the first fiscal year ending on or after 15th April, 2005.³⁹

Definition of internal control over financial reporting

For these purposes, 'internal control over financial reporting' is defined as a process designed by, or under the supervision of, the issuer's CEO and CFO, 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:

- 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 generally accepted accounting principles, and that receipts and expenditures of the issuer are being made only in accordance with authorisations of management and directors of the issuer; and
- provide reasonable assurance regarding prevention or timely detection of unauthorised acquisition, use or disposition of the issuer's assets that could have a material effect on the financial statements.⁴⁰

Management's annual assessment of, and report on, internal control

In an issuer's annual report on Form 20-F, management must provide a report on the issuer's internal control over financial reporting.⁴¹ The SEC has not required the use of a particular framework. It has, however, specified that management's evaluation must be based on a recognised control framework established by a body or group that has followed due-process procedures, including a broad distribution of the framework for public comment.⁴² The Committee of Sponsoring Organizations of the Treadway Commission's *Internal Control — Integrated Framework*, the Canadian Institute of Chartered Accountant's *Guidance on Assessing Control*, and the Institute of Chartered

Accountants in England and Wales' *Turnbull Report* are all approved frameworks.⁴³

The framework must:⁴⁴

- be free from bias;
- permit reasonably consistent qualitative and quantitative measures of an issuer's internal control;
- be sufficiently complete so that those relevant factors that would alter a conclusion about the effectiveness of an issuer's internal controls are not omitted; and
- be relevant to an evaluation of internal control over financial reporting.

Management may not determine that an issuer's internal control over financial reporting is effective if it identifies one or more material weaknesses in the issuer's internal control. The term 'material weaknesses' for these purposes has the same meaning as under the auditing standards of the PCAOB.

The SEC has not specified a method or procedures to be followed in the evaluation. An issuer must, however, maintain 'evidential matter, including documentation' to provide reasonable support for management's assessment of the issuer's internal control over financial reporting.⁴⁵ The assessment must be based on procedures sufficient both to evaluate design and to test operating effectiveness. The SEC has cautioned that inquiry alone generally will not provide an adequate basis for management's assessment.

In June 2004, the SEC issued answers to certain frequently asked questions regarding management's report over internal control (the '2004 FAQ').⁴⁶ Under the 2004 FAQ, among other things:

- *Qualifications:* Management may not qualify its conclusion about the effectiveness of an issuer's internal control, and may not conclude that internal control is effective if a material weakness exists. Instead, management may state that controls are ineffective for specific reasons.⁴⁷

- *Disclosure of significant deficiencies:* An issuer must identify and publicly disclose all material weaknesses. If management identifies a significant deficiency, it is not obligated to disclose publicly the existence or nature of the significant deficiency. If, however, management identifies a significant deficiency that, when combined with other significant deficiencies, is determined to be a material weakness, management must disclose the material weakness (and the significant deficiency to the extent needed to understand the material weakness). In addition, if a material change is made to either internal control or disclosure controls and procedures in response to a significant deficiency, the issuer should disclose the change and consider whether a discussion of the significant deficiency is needed.⁴⁸
- *Material business combinations:* If an issuer consummates a material business combination during a fiscal year and is unable to conduct an assessment of the acquired business's internal control during the period between the consummation date and the date of management's assessment, it may omit an assessment of the acquired business's internal control for not more than one year from the date of acquisition (and must make certain disclosure about the acquired business and the effect of the acquisition on the issuer's internal control).⁴⁹

Internal control audits — Auditing Standard No. 2⁵⁰

Auditing Standard No. 2 sets out the PCAOB's rules for internal control audits (the PCAOB chose to refer to an 'audit' rather than an 'attestation').⁵¹ The PCAOB stated that the objective of the internal control audit is to form an opinion as to whether management's assessment of the effectiveness of the issuer's internal control is fairly stated in all material respects.⁵² The auditor's conclusion will therefore relate

directly to whether the auditor can agree with management that internal control is effective.⁵³ In this connection, the auditor needs to evaluate management's assessment process (to ensure that management has an appropriate basis for its conclusion) and to test the effectiveness of internal control.⁵⁴

Significant deficiencies and material weaknesses

Under Auditing Standard No. 2, both management and the auditor may identify deficiencies in internal control.⁵⁵ A control deficiency exists 'when the design or operation of a control does not allow the company's management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis'.⁵⁶

Auditing Standard No. 2 provides that a control deficiency should be classified as a 'significant deficiency' if, 'by itself or in a combination with other control deficiencies, it results in more than a remote likelihood of a misstatement of the company's annual or interim financial statements that is more than inconsequential will not be prevented or detected'.⁵⁷ In addition, a 'significant deficiency' should be classified as a material weakness if, by itself or in combination with other control deficiencies, it results in more than a remote likelihood that a material misstatement in the company's annual or interim financial statements will not be prevented or detected'.⁵⁸

Auditing Standard No. 2 mandates that an auditor must communicate in writing to the audit committee all significant deficiencies and material weaknesses of which the auditor is aware.⁵⁹ In addition, the auditor must communicate to management, in writing, all control deficiencies of which the auditor is aware that have not previously been communicated in writing to management and notify the audit committee of such a communication.⁶⁰

Identifying significant deficiencies

Auditing Standard No. 2 identifies a number of circumstances that, 'because of their likely significant negative effect on internal control are significant deficiencies as well as strong indicators that a material weakness exists'.⁶¹ These include:⁶²

- ineffective oversight by the audit committee of the issuer's external financial reporting and internal control. As part of evaluating the control environment, an auditor must assess the effectiveness of the audit committee's oversight and must communicate to the board of directors if it concludes that oversight is ineffective;
- material misstatement in the financial statements not initially identified by the issuer's internal control. Failure to detect the misstatement is 'a strong indicator that the company's internal control' is ineffective; and
- significant deficiencies that have been communicated to management and the audit committee, but that remain uncorrected after reasonable periods of time.

Auditor's report

An auditor may express an unqualified opinion if it has identified no material weaknesses.⁶³ If the auditor cannot perform all of the necessary procedures, the auditor may either qualify or disclaim an opinion.⁶⁴ If an overall opinion cannot be expressed, Auditing Standard No. 2 requires the auditor to explain why.⁶⁵

Under Auditing Standard No. 2, the auditor's report includes two opinions: one on management's assessment of internal control and one on the effectiveness of internal control.⁶⁶ The auditor's report may disclose only material weaknesses, although if an aggregation of significant deficiencies constituted a material weakness, then disclosure would be required.⁶⁷ Auditing Stan-

dard No. 2 does not permit a qualified opinion on the effectiveness of internal control in the event of a material weakness; instead, the auditor must express an 'adverse opinion'.⁶⁸ The auditor may express an unqualified opinion on management's assessment so long as management properly identifies the material weakness and concludes that internal control was not effective.⁶⁹ If, however, the auditor and management disagree about the existence of the material weakness, then the auditor would render an adverse opinion on management's assessment.⁷⁰

NYSE AND NASDAQ REQUIREMENTS FOR AUDIT COMMITTEES

Both the NYSE and NASDAQ have passed new corporate governance requirements, including requirements relating to audit committees. The key aspects of these rules are summarised below.

NYSE

The NYSE permits foreign private issuers to follow home country practice in lieu of the NYSE's corporate governance standards, other than (with respect to audit committees) the NYSE's requirement that it must have an audit committee that meets the requirements of Rule 10A-3.⁷¹

NASDAQ

NASDAQ takes a different approach to foreign private issuer compliance with its corporate governance rules than does the NYSE. Under the NASDAQ rules, a listed foreign private issuer may obtain exemptions from NASDAQ corporate governance standards if those rules would require the issuer to act contrary to applicable laws, rules, regulations, or generally accepted business practices of the issuer's home country, except to the extent that exemption would be contrary to the US federal securities laws (including Rule 10A-3 relating to listed company audit committees).⁷²

The NASDAQ rules require a quoted company's audit committee to meet requirements including:

- *Sarbanes–Oxley*:⁷³ An issuer's audit committee must satisfy the independence and other requirements of Rule 10A-3.
- *Charter*:⁷⁴ Each issuer must certify that it has a written charter and that the audit committee has reviewed and assessed the adequacy of the audit committee charter on an annual basis. The charter must specify, among other things, the scope of the audit committee's responsibilities, the audit committee's responsibility for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the issuer, and the committee's purpose of overseeing the accounting and financial reporting processes of the issuer and the audits of the financial statements of the issuer.
- *Composition*:⁷⁵ The issuer must have, and certify that it has and will continue to have, an audit committee of at least three members, each of whom must meet certain requirements, including the ability to read and understand fundamental financial statements. In addition, each issuer must certify that it has, and will continue to have, one member of the audit committee who has past employment experience in finance or accounting or other comparable experience or background which results in financial sophistication. (A director who qualifies as an 'audit committee financial expert' under the SEC's rules will be deemed to meet this financial sophistication requirement.)⁷⁶

CONCLUSION

One of the key policy goals of the Sarbanes–Oxley Act was to increase oversight over financial reporting and financial control. An issuer's audit committee is at the heart of that

process, and the Act greatly expands the duties of audit committees.

Prior to the Sarbanes–Oxley Act, the role of the audit committee — if any — was a matter of the local corporate law under which a foreign private issuer was organised, and the listing rules of exchange on which its securities were listed. The Act has thrust US federal securities regulation into that area, to the surprise of many foreign private issuers.

While the SEC has, in its implementing rules, made various exceptions for the benefit of foreign private issuers, the Act continues to have a profound impact on those companies' audit committees. The full weight effect of Sarbanes–Oxley will only be felt when the internal control rules of Section 404 come completely into effect.

REFERENCES

- 1 Sarbanes–Oxley Act Section 2(a)(7).
- 2 1934 Act, Rule 10A-3(a)(5)(i)(A); see also Standards Relating to Listed Company Audit Committees, Securities Act Release No. 8220, Exchange Act Release No. 47654, Investment Company Act Release No. 26001 (9th April, 2003).
- 3 1934 Act, Rule 10A-3(b)(1)(i).
- 4 1934 Act, Rule 10A-3(b)(1)(ii)(A).
- 5 1934 Act, Rule 10A-3(b)(1)(ii)(B).
- 6 1934 Act, Rule 10A-3(e)(1)(i).
- 7 1934 Act, Rule 10A-3(e)(1)(ii)(A).
- 8 1934 Act, Rule 10A-3(b)(1)(iv)(C).
- 9 1934 Act, Rule 10A-3(b)(1)(iv)(D).
- 10 1934 Act, Rule 10A-3(b)(1)(iv)(E).
- 11 1934 Act, Rule 10A-3(b)(2).
- 12 1934 Act, Rule 10A-3(b)(3).
- 13 1934 Act, Rule 10A-3(b)(4).
- 14 1934 Act, Rule 10A-3(b)(5).
- 15 Instruction 1 to 1934 Act, Rule 10A-3.
- 16 *Ibid.*
- 17 Instruction 2 to 1934 Act, Rule 10A-3.
- 18 1934 Act, Rule 10A-3(c)(3).
- 19 1934 Act, Rule 10A-3(d) and Form 20-F, Item 16.D.
- 20 Form 20-F, Items 16A(a)(1) and (3).
- 21 *Ibid.*, Instruction 3 to Item 16A.
- 22 *Ibid.*, Item 16A(a)(2).

- 23 *Ibid.*
- 24 *Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002*, Securities Act Release No. 8177, Exchange Act Release No. 47234 (as corrected 24th January, 2003), Fed. Sec. L. Rep. 86,818 at 86,885.
- 25 *Ibid.*, Item 16A(b).
- 26 *Ibid.*, Item 16A(c).
- 27 *Ibid.*, Instruction 3 to Item 16A.
- 28 Sections 406 and 407 Adopting Release, Section II.A.4.d.i.
- 29 Form 20-F, Item 16A(d)(1).
- 30 *Ibid.*, Items 16A(d)(2)-(3).
- 31 *Strengthening the Commission's Requirements Regarding Auditor Independence*, Securities Act Release No. 8183, Exchange Act Release No. 47265, Investment Company Act Release No. 25915, Investment Advisers Act Release No. 2103 (28th January, 2003).
- 32 S-X Rule 2-01(c)(7); see also 1934 Act, Sections 10A(h)-(i) (all audit and permitted non-audit services must be pre-approved by the audit committee (subject to certain *de minimis* exceptions)). The SEC has stated that an issuer's audit committee must follow three requirements in its use of pre-approval through policies and procedures. First, the policies and procedures must be detailed as to the particular service to be provided. Secondly, the audit committee must be informed about each service. Thirdly, the policies and procedures cannot result in the delegation of the audit committee's authority to management. Accordingly, monetary limits cannot be the only basis for the pre-approval policies and procedures. SEC Office of the Chief Accountant, *Application of the January 2003 Rules on Auditor Independence — Frequently Asked Questions*, Question 22. Note that under Auditing Standard No. 2 of the PCAOB, an issuer's audit committee cannot pre-approve internal control services as a category, but must instead approve each service.
- 33 S-X Rule 2-07(a); see also 1934 Act, Section 10A(k) (substantially identical requirements).
- 34 *Ibid.*, Item 16C(e).
- 35 *Improper Influence on Conduct of Audits*, Exchange Act Release No. 47890, Investment Company Act Release No. 26050, Financial Reporting Release No. 71 (20th May, 2003).
- 36 1934 Act, Rule 13b2-2(b)(1).
- 37 1934 Act, Rule 13b2-2(b)(2).
- 38 Public Company Accounting Oversight Board, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*, PCAOB Release No. 2004-001, PCAOB Rulemaking Docket Matter No. 008 (9th March, 2004) [hereinafter Auditing Standard No. 2 Release].
- 39 *Management's Reports on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports*, Securities Act Release No. 8238, Exchange Act Release No. 47986, Investment Company Act Release No. 26068 (5th June, 2003), Section IIJ [hereinafter Management's Reports on Internal Control Adopting Release].
- 40 1934 Act, Rules 13a-15(f); 15d-15(f).
- 41 Form 20-F, Item 15(b). That report must contain, among other things:
- 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 evaluate the effectiveness of the issuer's internal control over financial reporting;
 - management's assessment of the effectiveness of the issuer's internal control over financial reporting as of the end of the most recent fiscal year, including a statement as to whether or not the issuer's internal control over financial reporting is effective;
 - a statement that the independent auditor 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; and
 - disclosure of any change in its internal control that occurred during the fiscal

- year that has materially affected, or is reasonably likely to materially affect, the issuer's internal control over financial reporting.
- 42 Management's Reports on Internal Control Adopting Release, Section II.B.3.a.
- 43 *Ibid.*, at n. 67.
- 44 *Ibid.*
- 45 Form 20-F, Instruction 1 to Item 15. The SEC has stated that it believes it is important for the internal control report to be located near the auditor's attestation report, and that it expects issuers will place the report and attestation near MD&A disclosure or immediately preceding the financial statements. Management's Reports on Internal Control Adopting Release, Section II.B.3.e.
- 46 Office of the Chief Accountant, Division of Corporation Finance, *Management's Report on Internal Control over Financial Reporting and Disclosure in Exchange Act Periodic Reports: Frequently Asked Questions* (22nd June, 2004).
- 47 *Ibid.*, Question 5.
- 48 *Ibid.*, Question 11.
- 49 *Ibid.*, Question 3.
- 50 Auditing Standard No. 2 Release, at 6.
- 51 The PCAOB believed that 'attestation' was 'insufficient to describe the process of assessing management's report on internal controls'. *Ibid.*, at 6.
- 52 *Ibid.*, at 7.
- 53 *Ibid.*
- 54 *Ibid.*
- 55 *Ibid.*, at 19.
- 56 *Ibid.*
- 57 *Ibid.*
- 58 *Ibid.*
- 59 *Ibid.*, at 20.
- 60 *Ibid.*
- 61 *Ibid.*
- 62 *Ibid.*, at 20–21.
- 63 *Ibid.*, at 22.
- 64 *Ibid.*
- 65 *Ibid.*
- 66 *Ibid.*, at 23.
- 67 *Ibid.*
- 68 *Ibid.*, at 24.
- 69 *Ibid.*
- 70 *Ibid.*
- 71 NYSE Listed Company Manual, section 303A.00.
- 72 National Association of Securities Dealers, Inc., *NASD Manual*, Rule 4350(a)(1).
- 73 *Ibid.*, IM-4350(d).
- 74 *Ibid.*, Rule 4350(d)(1).
- 75 *Ibid.*, Rule 4350(d)(2).
- 76 *Ibid.*, IM-4350-4.

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