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What Public Companies Need To Know About This Year's Annual Reports

A great amount of attention has been devoted to the sea change in corporate governance that has resulted from the Sarbanes-Oxley Act of 2002, Securities and Exchange Commission rulemaking and stock exchange listing proposals. But beyond the headlines, what does it all mean for a public company just trying to have complete, up-to-date filings? This advisory presents some of the key issues[1] that clients should keep in mind in the upcoming months while preparing annual disclosure documents:

CURRENTLY EFFECTIVE RULES

CEO and CFO Certifications. There are currently two sets of CEO/CFO certifications that must accompany each Annual Report on Form 10-K. For calendar fiscal year companies, these are essentially the same certifications filed with the last Quarterly Report on Form 10-Q.

10-Ks must now be accompanied by statements by the chief executive officer and chief financial officer certifying that the 10-K fully complies with applicable securities law requirements and that the information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer (the so-called "906" certifications).

CEOs and CFOs of public companies must also certify the accuracy of each 10-K filed with the SEC, including their financial statements. Specifically, CEOs and CFOs will have to include the exact certifications attached to this advisory as Exhibit A (the so-called "302 certifications").

For a summary of the rules relating to CEO and CFO certifications and related practical guidance, see our August 2002 client advisory: "Certifications by Principal Executive Officers and Principal Financial Officers" and our September 2002 client advisory: "SEC Requires Additional CEO and CFO Certifications," each available at www.zag-sw.com.

Disclosure Controls and Procedures. The SEC now requires public companies to have *"disclosure controls and procedures."* The SEC defines this term as the controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files under the Securities Exchange Act of 1934 (the "Exchange Act") is recorded, processed, summarized and reported within required time periods. *"Internal controls"* are partially subsumed under disclosure controls and procedures. Internal controls and procedures should ensure that companies have processes designed to provide reasonable assurance that the company's transactions are properly authorized, the company's assets are safeguarded against unauthorized or improper use and the company's transactions are properly recorded and reported in order to permit the preparation of the company's financial statements in conformity with generally accepted accounting principles.[2]

A new item in the 10-K, similar to an item that is now required in 10-Qs, requires disclosure of the conclusions of the CEO and CFO about the effectiveness of the company's disclosure controls and procedures based on their evaluation as of a date within 90 days of the filing date of the 10-K. The 10-K will also require disclosure about whether or not there were any significant changes to the company's

[1] This advisory is not intended to cover changes that might affect the preparation of financial statements or other financial information.

[2] For a discussion of proposed SEC rules relating to internal controls, see our October 2002 client advisory: "SEC Proposes New Disclosure Regarding Financial Experts, Internal Controls and Codes of Ethics," available at www.zag-sw.com.

internal controls or in other factors that could significantly affect these controls subsequent to the date of evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Equity Compensation Plan Disclosure. Last year, the SEC amended its rules to require greater disclosure of equity compensation plan information in 10-Ks. For calendar fiscal year companies, this year's 10-K will be the first time these rules are applicable. The new disclosure is required for all arrangements under which equity compensation may be issued, including arrangements for non-employees, such as directors, consultants, advisors, vendors, customers, suppliers or lenders, and for individual arrangements, even if not pursuant to a broader plan.

Companies are now required to provide detailed information for each equity compensation plan in effect as of the end of the fiscal year, regarding (1) the number of outstanding options, warrants and rights outstanding, (2) the number of securities remaining available for future issuance under those plans, (3) the weighted-average exercise price of such outstanding options, warrants and rights and (4) which plans were approved by stockholders. The information is required to appear in tabular form. For non-stockholder approved plans, additional information will be required in narrative form and the plans will need to be filed as exhibits to the 10-K.

In addition, if a compensation plan (even a cash-only plan) will be submitted to the stockholders for approval, this new disclosure must appear in the related proxy statement.

Website Access and Website Disclosure; Change to 10-K Cover Page. In the 10-K, "accelerated filers" are required to disclose where investors can obtain access to their SEC filings, including whether the company makes its periodic and current reports available on its website, free of charge, as soon as reasonably practicable after they are electronically filed with, or furnished to, the SEC. "As soon as reasonably practicable" essentially means the same day as filing. These rules became effective November 15, 2002, so for this year's 10-K, companies need only cover the period from November 15 through the end of the year. For example, if a company did not begin making its filings available until the middle of 2002, it can still make affirmative disclosure as long as it made its filings available as soon as practicable for the period from November 15 through December 31.

"Accelerated filers" are companies which at the end of their fiscal year:

- have a public float (i.e., voting and non-voting common equity not held by affiliates of the company) of $75 million as of the last day of its most recently completed second fiscal quarter;
- have been filing periodic reports (e.g., 10-Ks and 10-Qs) under the Exchange Act for at least 12 months;
- have filed at least one annual report; and
- are not eligible to file 10-K and 10-Q forms applicable to small business issuers.

If an accelerated filer does not provide such access to its filings, the new rules require that the company explain in the 10-K why it does not provide access. The company must also include its website address, if it has one, in its 10-K and disclose whether the company will voluntarily provide electronic or paper copies of its filings free of charge upon request.

Though these rules only require disclosure and not actual posting or access, the SEC strongly encourages that companies make filings available to ensure that the disclosure is more readily available to investors on a timely basis and to promote efficiency in the capital markets by enabling investors to make informed investment decisions. The SEC has stated that available filings should go back in time at least 12 months and must include all exhibits. For companies that link to a third-party site, the SEC recommends that companies should link directly to the report or a list of reports rather than simply providing a link to the third party's home page. Hyperlinking to the company's filings on the SEC's EDGAR site will be considered "as soon as reasonably practicable."

A revised cover page for 10-Ks now requires a company to indicate whether it is an accelerated filer. The cover page must also now contain a statement of the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the company's most recently completed second fiscal quarter.

PROPOSED RULES

MD&A: Critical Accounting Policies and Estimates. The proposed rules would augment current disclosures of critical accounting policies by requiring additional qualitative and quantitative analyses of the sensitivity of the judgments and estimates underlying critical accounting policies. A company would have to identify the accounting estimates reflected in its financial statements that required it to make assumptions about matters that were highly uncertain at the time of estimation.

If different estimates in the period, or changes in the accounting estimates, are reasonably likely to occur from period to period, and those differences or changes would have a material impact on the presentation of the company's financial condition, changes in financial condition or results of operations, additional disclosures would be required. In those cases, MD&A would need to include a discussion of the methodology and assumptions underlying the estimates, the effect the estimates have on the company's financial presentation, and the effect of changes in the estimates.

A company that had adopted an accounting policy with a material impact would have to disclose information that includes what gave rise to the initial adoption, the impact of the adoption, the accounting principle adopted and method of applying it, and the choices it had among accounting principles.

Repurchase Programs. Proposed rules would require 10-Ks (and 10-Qs) to disclose the total number of shares repurchased under stock repurchase programs during the past quarter, the average price paid per share, the identity of any broker-dealers used to effect the purchases, the number of shares purchased as part of a publicly announced repurchase plan or program, and the number of shares remaining to be purchased under the plan or program.

RULES EFFECTIVE IN THE FUTURE AND OTHER CHANGES TO CONSIDER

Audit Committee Charter. The New York Stock Exchange has proposed rules that would increase what is required to appear in, and be covered by, audit committee charters. As these changes are only at the proposed stage and could change, companies may want to wait before changing their charters. Other changes, however, as a result of the Sarbanes-Oxley Act and evolving best practices may be appropriate and audit committees should (and are usually required to) evaluate their charters to decide what changes would be appropriate for this year's proxy season. Revised audit committee charters may need to be included as part of the proxy statement.

Acceleration of Filing of Annual and Quarterly Reports. The new accelerated filing deadlines for accelerated filers (see ***Website Access and Website Disclosure; Change to 10-K Cover Page*** above) will not apply to the current 10-K, but will commence for 10-Ks for fiscal years ending on or after December 15, 2003 and for 10-Qs for quarters ending on or after December 15, 2003[3]. Companies that are not accelerated filers can continue to comply with the currently existing, longer deadlines.

NYSE/Nasdaq Corporate Governance Proposals. The New York Stock Exchange and Nasdaq have submitted to the SEC extensive proposed changes to their listing standards, most notably in the area of corporate governance. Both have proposed requiring stockholder approval of most option plans and amendments to option plans. The SEC is expected to finalize these revised standards shortly, and they may impact the upcoming annual reporting season as companies consider what items to submit to stockholders at their annual meetings.

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[3] For a discussion of the accelerated filing deadlines, see our September 2002 client advisory: "Deadlines for Annual and Quarterly Reports Accelerated; New Disclosure Required Regarding Reports on Websites," available at www.sandw.com.

Many of the proposed changes would require additional disclosure in proxy statements and annual reports. While the SEC is expected to publish these proposals for public comment in the near future, they are not likely to be finalized prior to the upcoming annual reporting season.

Section 16 Reporting Issues. Under recent rule changes, reports of changes of beneficial ownership on Form 4 by directors, officers and 10% stockholders are required to be filed by the second business day after a transaction. Companies and insiders should be aware that a transaction that occurred prior to August 29 that was eligible for deferred year-end reporting on Form 5 will be timely reported if a Form 5 is filed by February 14. This is true even if subsequent to August 29, the same transaction would have been reportable within 2 business days instead of after the end of the year. Proxies must disclose whether any such reports were late, and so a reporting company should carefully research whether any reports were not timely filed, particularly after August 29, the effective date of the rule change. Beginning no later than July 29, 2003, all of these reports will need to be filed electronically.

Non-GAAP Financial Measures. Under new SEC rules, whenever a "non-GAAP financial measure" is included in an SEC filing for a period ending after March 28, 2003, a company also needs to include certain information such as a quantitative reconciliation with the most comparable GAAP financial measure, a statement regarding the purposes for which management uses the non-GAAP financial measure and a statement as to why management believes the presentation of the non-GAAP financial measure is useful to investors.[4] There are also limits on the prominence of non-GAAP financial measures and on what they are permitted to include and exclude.

A non-GAAP financial measure is defined as a numerical measure of a company's historical or future financial performance, financial position or cash flows that (1) excludes amounts, or is subject to adjustments that have the effect of excluding amounts, that are included in the comparable measure calculated and presented in accordance with GAAP in the statement of income, balance sheet or statement of cash flows, or (2) includes amounts, or is subject to adjustments that have the effect of including amounts, that are excluded from the comparable measure so calculated and presented. A common example is the use of EBITDA when disclosing financial results. Non-GAAP financial measures do not include certain operating and other statistical measures, such as unit sales or number of employees.

Code of Ethics. Beginning with fiscal years ending after July 15, 2003 (or after December 15, 2003 for small business issuers), a public company will need to disclose in its 10-K whether it has adopted a written code of ethics that applies to its CEO, CFO, principal accounting officer or controller, or persons performing similar functions, or if it has not, an explanation of why it has not. A company will need to make available to the public a copy of its code of ethics (if it has one), either by (1) filing it as an exhibit to its 10-K, (2) posting it on the company's website if it has disclosed in its 10-K the company's website address and that the code of ethics is available on that website or (3) if it undertakes to do so in its 10-K, by agreeing to provide a free copy upon request. Amendments to, and waivers under, the code of ethics relating to any of the specified officers will have to be filed on either a Form 8-K or on the company's website within five business days. Website disclosure of amendments and waivers would be permitted only if the company discloses its intention to do so in its 10-K.

A code of ethics is defined as written standards that are reasonably designed to deter wrongdoing and to promote (1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships; (2) full, fair, accurate, timely and understandable disclosure in reports and documents that a company files with, or submits to, the SEC and in other public communications; (3) compliance with applicable governmental laws, rules and regulations; (4) the prompt internal reporting of violations of the code to appropriate persons identified in the code; and (5) accountability for adherence to the code. An effective code of ethics should describe the company's system for the internal reporting of code violations and should state clearly the consequences of non-adherence to code provisions.

Note that although this is merely a disclosure requirement, the NYSE and Nasdaq have proposed requiring that listed

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[4] For a discussion of the SEC rules relating to non-GAAP financial measures, as well as the filing of earnings releases on Form 8-K, see our January 2003 client advisory: "New Disclosure Required for Non-GAAP Financial Measures," available at www.zag-sw.com.

companies actually adopt a code of ethics and disclose waivers not only for the SEC's specified officers, but also for directors, additional officers and employees.

Financial Experts. Beginning with fiscal years ending after July 15, 2003 (or after December 15, 2003 for small business issuers), a public company will be required to disclose in its 10-K whether it has at least one "audit committee financial expert" serving on the company's audit committee. If so, the company must name the expert(s) and disclose whether he or she is independent of management. Companies without audit committee financial experts will need to explain why they have none.

The new rules define "audit committee financial expert" as a person who has (1) an understanding of GAAP and financial statements; (2) an ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves; (3) experience preparing or auditing financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and level of complexity of issues that can reasonably be expected to be raised by the company's financial statements or experience actively supervising one or more persons engaged in such activities; (4) an understanding of internal controls and procedures for financial reporting; and (5) an understanding of audit committee functions.[5] The rules contemplate that a person would obtain these attributes through (1) education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions; (2) experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions; (3) experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or (4) other relevant experience. If a person qualifies due to "other relevant experience," the disclosure must briefly list that person's experience. The board of directors will make the determination as to whether a particular person qualifies as an audit committee financial expert.

Auditor Independence and Fee Disclosure. The SEC has issued a series of rules under the Sarbanes-Oxley Act designed to enhance the independence of accountants that audit financial statements filed with the SEC. These rules, among other things, revise SEC regulations related to the non-audit services that, if provided to an audit client, impair an accounting firm's independence. A company's auditors are not permitted to perform the enumerated services. Some non-audit services, however, such as certain tax services, are still permitted to be performed by the auditors without compromising their independence. The rules require that a company's audit committee pre-approve all audit and permissible non-audit services provided to the company by its auditors. The audit committee's policies and procedures for pre-approving these services will need to be disclosed in a company's 10-K and annual proxy statement for fiscal years ending after December 15, 2003.

In addition, under these rules, disclosure relating to the fees paid by companies to their auditors will be expanded. Currently effective rules require disclosure of the audit fees, financial information systems design and implementation fees and all other fees paid to the auditors for the past year. These categories will be changed to audit fees, audit-related fees, tax fees and other fees and will cover the prior two years and require additional descriptions about the fees.[6] In addition, the percentage of each category of fees approved by the audit committee will need to be listed. If greater than 50%, the percentage of hours expended on the auditors' engagement to audit the most recent year's financial statements that were attributed to work performed by persons other than the principal auditors' full-time, permanent employees will also need to be disclosed.

MD&A: Off-balance Sheet Arrangements. New rules require companies to disclose in greater detail in MD&A sections of their 10-Ks (with updates in 10-Qs) all material off-balance sheet arrangements that have, or are reasonably likely to have, a material

[5] The rules provide a safe harbor to make clear that an audit committee financial expert is not deemed an "expert" for any purpose, including for purposes of Section 11 of the Securities Act of 1933, and that the designation of a person as an audit committee financial expert does not impose any duties, obligations or liabilities on the person that are greater than those imposed on such a person as a member of the audit committee in the absence of such designation, nor does it affect the duties, obligations or liabilities of any other member of the audit committee or board of directors.

[6] Financial systems design and implementation fees have been eliminated because these services have been mostly prohibited under the proposed rules described above relating to non-audit services.

current or future effect on financial condition, changes in financial condition, results of operations, liquidity, capital expenditures, capital resources or significant components of revenues or expenses. The disclosure needs to include the nature and business purpose, the importance to the issuer for liquidity, capital resources, market risk or credit risk support or other benefits, the financial impact and exposure to risk and known events, demands, commitments, trends or uncertainties that implicate the company's ability to benefit from its off-balance sheet arrangements. Companies will need to consider disclosing additional information necessary for an understanding of their off-balance sheet arrangements and their material effects. The disclosure is intended to provide insight into the overall magnitude of these activities, their impact and the circumstances that could cause material contingent obligations or liabilities to come to fruition. Companies must comply with these rules for registration statements, 10-Ks and proxy statements required to include financial statements for fiscal years ending on or after June 15, 2003.

MD&A: Contractual Obligations. The revised MD&A rules also require a company to provide an overview of its aggregate contractual obligations in a tabular format in registration statements, 10-Ks and proxy statements required to include financial statements for fiscal years ending on or after December 15, 2003. The table must include the amounts of contractual obligations, aggregated by type for periods of less than one year, 1 to 3 years, 3 to 5 years and more than 5 years, in categories such as long-term debt, capital lease obligations, operating leases, unconditional purchase obligations and other long-term obligations.

* * *

As a result of the series of high profile corporate failures, Congress acted with great speed to pass the Sarbanes-Oxley Act. The SEC and stock exchanges are scrambling to keep up with its mandated rule changes. The SEC's rules and the Sarbanes-Oxley Act emphasize a trend of increased but more transparent disclosure. The SEC has stated that it is not sufficient to merely adhere to technical rules and that disclosure must be complete, understandable and not misleading.

The summary above is meant to describe the major changes affecting upcoming 10-Ks and proxy statements. To discuss these topics or other matters relating to annual reporting, please contact your lawyer at ZAG/S&W LLP or the lawyer below.

Howard E. Berkenblit
February 2003

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Because sound legal advice must necessarily take into account all relevant facts and developments in the law, the information you will find in this memorandum is not intended to constitute legal advice or a legal opinion as to any particular matter.

Exhibit A

CERTIFICATIONS

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

1. I have reviewed this annual report on Form 10-K of [identify registrant];

2. Based on my knowledge, this annual 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 annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual 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 annual report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

    a) designed such disclosure controls and procedures 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 annual report is being prepared;

    b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the "Evaluation Date"); and

    c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

    a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and

    b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

6. The registrant's other certifying officers and I have indicated in this annual report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date:______________

____
[Signature]
[Title]