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SARBANES-OXLEY AND ITS IMPORT/EXPORT IMPLICATIONS

The Sarbanes-Oxley Act of 2002 imposed significant new Securities and Exchange Commission (SEC) reporting obligations on publicly-held companies. Among these is Section 404, which requires a company's annual report -

to contain an internal control report, which shall -

(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

(2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

This summary addresses the effect of Section 404 on import and export (trade) compliance issues and the law's potential impact on a company's organizational structure.

The SEC proposed rules to implement section 404 on October 30, 2002. 67 Fed. Reg. 66208. The proposed rule stated at § 240.13a-14(d) -

For purposes of this section and § 240.13a-15, the term *internal controls and procedures for financial reporting* means controls that pertain to the preparation of financial statements for external purposes that are fairly presented in conformity with generally accepted accounting principles as addressed by the Codification of Statements on Auditing Standards § 319 or any superseding definition or other literature that is issued or adopted by the Public Company Accounting Oversight Board.

In its proposal, the SEC recognized that the definition of internal controls and procedures was the key aspect to the implementation of section 404, but also acknowledged that "because there are a variety of definitions of the term "internal controls" and its meaning has changed over time, there continues

to be confusion regarding the meaning and scope of the term." 67 Fed. Reg. at 66219.

At the conclusion of its discussion of the proposed definition, the SEC stated:

In 1992, the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") undertook an extensive study of internal control. COSO defined internal control as "a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives" in three categories—effectiveness and efficiency of operations, reliability of financial reporting, and **compliance with applicable laws and regulations**. COSO further stated that internal control over each of these objectives consisted of the control environment, risk assessment, control activities, information and communication, and monitoring. In 1995, the AICPA's Auditing Standards Board in Statement on Auditing Standards No. 78 codified this definition of internal controls.

We believe that the purpose of internal controls and procedures for financial reporting is to 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 to permit the preparation of the registrant's financial statements in conformity with generally accepted accounting principles.

We believe that these objectives are embodied in the definition of the term "internal controls" as the term is defined in AICPA's Codification of Statements on Auditing Standards (AU) section 319 and is consistent with section 103 of the Sarbanes-Oxley Act.

Accordingly, we propose to refer to AU section 319 to define current[] internal controls and procedures for financial reporting, pending action by the Public Company Accounting Oversight Board. The proposed definition would state that the term "internal controls and procedures for financial reporting" means controls that pertain to the preparation of financial statements for external purposes that are fairly presented in conformity with generally accepted accounting

principles as addressed by the Codification of Statements on Auditing Standards 319 or any superseding definition or other literature that is issued or adopted by the Public Company Accounting Oversight Board.

67 Fed. Reg. at 66220 (emphasis added). Thus, the proposed definition was quite broad, seemingly requiring management to determine whether the company's internal controls and procedures were adequate to ensure compliance with all laws and regulations applicable to the company's activities.

The final regulation adopted by SEC modified the proposed definition of the term "internal control over financial reporting." 68 Fed. Reg. 36636 (June 18, 2003).

The term *internal control over financial reporting* is defined as 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 statement 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.

§ 240.13a-15(f). The final definition therefore backed away from the broad reach of the proposed definition of internal controls, a conclusion supported by the SEC's discussion of the proposed regulation and the comments received thereto. By repeating an earlier statement, the SEC first elaborated on the proposed definition:

In 1992, COSO [the Committee of Sponsoring Organizations of the Treadway Commission] published its *Internal Control-Integrated Framework*. The COSO Framework defined internal control as "a process effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives" in three categories - effectiveness and efficiency of operations; reliability of financial reporting; and compliance with applicable laws and regulations. COSO further stated that internal control consists of: the control environment, risk assessment, control activities, information and communication, and monitoring. The scope of internal control therefore extends to policies, plans, procedures, processes, systems, activities, functions, projects, initiatives, and endeavors of all types at all levels of a company.

Then, after analyzing the 25 comments it received in response to the proposed definition, the SEC concluded:

We recognize that our definition of the term "internal control over financial reporting" reflected in the final rules encompasses the subset of internal controls addressed in the COSO Report that pertains to financial reporting objectives. Our definition does not encompass the elements of the COSO Report definition that relate to effectiveness and efficiency of a company's operations and a company's compliance with applicable laws and regulations, with the exception of compliance with the applicable laws and regulations directly related to the preparation of financial statements, such as the Commission's financial reporting requirements.

* * *

Our definition also includes, in clause (3), explicit reference to assurances regarding use or disposition of the company's assets. This provision is specifically included to make clear that, for purposes of our definition, the safeguarding of assets is one of the elements of internal control over financial reporting .

. . .

68 Fed. Reg. at 36640. Thus, the direct scope of the internal control requirements as it applies to section 404 of Sarbanes-Oxley is limited to financial controls and the protection of a company's assets.

With respect to the internal controls developed by a company to ensure compliance with the import and export laws and regulations, the section 404 reporting requirements come into

play only when those controls are inadequate to protect the company's assets and thereby protect shareholder value. We conclude, therefore, that management has a certain degree, if not a clearly defined level, of responsibility over the reliability of the internal controls over its trade compliance.

If a company fails to have adequate internal controls in place, it is unable to move its goods to market in a timely and cost-efficient fashion, thereby dramatically and perhaps fatally impacting its bottom line and so seriously decreasing shareholder value if not outright eliminating it. Similarly, without adequate internal controls, a company opens itself up to be possibly hit with duty increase bills, unexpected dumping bills, seized goods and related costs, penalties and the like which similarly undermine the value of its shares to the serious detriment of its shareholders. All of this is in addition to any brand name damage which might arise from the inability to deliver goods or to be associated publicly with negative press such as drug seizures, social accountability violations and/or suspected terrorist activities.

The use of internal controls to measure a company's level of Customs compliance arises out of the Customs Modernization Act, enacted as part of the North American Free Trade Agreement legislation in 1993. It resulted in Customs developing a regulatory audit regime that focuses on the internal controls adopted by a company to manage its Customs compliance risks. The internal controls objectives established by Customs are those adopted as set forth in the COSO Framework.

In this audit environment, Customs' first step in a Focused Assessment (FA) of an importer's Customs transactions is to review the company's internal controls. If Customs determines the internal controls are adequate to manage the company's compliance risks, the auditors generally do not review specific transactions or conduct other analyses in depth in order to test compliance, although that may be done for other reasons.

More importantly, Customs also developed the Importer Self Assessment (ISA) program wherein an importer, using a plan approved by Customs, periodically tests the adequacy of its own internal controls, reporting and correcting any deficiencies in a defined manner.

On the export side, a similar responsibility lies with management and the board. The Bureau of Industry and Security (formerly the Bureau of Export Administration) has provided the most easily understood definition - a company is barred from self-blinding - if the circumstances surrounding the transaction should have led to the asking of more questions, the company simply cannot ignore those red flags.

In the current environment, there are also a multitude of lists detailing prohibited end users and prohibited end uses. In determining whether a company has met its Sarbanes-Oxley obligations, many factors enter into the decision-making process and are too numerous to list here. Federal agencies publishing these lists include the Office of Foreign Assets Control and the Departments of Commerce, State and Treasury. In each instance, a recognized mitigating factor in the face of any penalty is the adequacy of the company's compliance program, which by definition means the constant revisions necessary to meet the ever-changing regulatory environment facing international traders. Similarly, the federal sentencing guidelines call for a downward reduction of the mandatory sentence if the crime arose from circumstances which were not handled in accord with the company's existing internal controls.

Against this backdrop, Sarbanes-Oxley requires proper internal controls to insure exports flow smoothly, and the failure of that to happen has as much consequence to a company's bottom line as any Customs hold for inspection/additional information, duty increase bill, fine, seizure or the like. Similarly, the selection of carriers and truckers is no longer something which can simply be delegated to third parties, nor can compliance with shipping terms and contracts.

We have sought here to, in general, alert companies to the importance of including their import and export functions in any Sarbanes-Oxley analysis. However, there is one additional important consideration - where the trade compliance function should reside within a company's structure. In this context, we consider the compliance function to be the day-to-day operations that result in the company's interaction with the various federal agencies with jurisdiction over its imports and exports.

Where precisely the trade compliance function should reside depends on exactly how a company is structured. Generally, however, trade compliance is best left in the hands of those most familiar with its requirements and the company's internal controls.

In that same vein, careful thought should be given to whether it is appropriate for the first-line Sarbanes-Oxley or trade compliance function to be based within a company's in-house legal organization. The Sarbanes-Oxley legislation makes clear that the attorney-client relationship, and the attorney-client privilege, exists between counsel and the entity as a whole. To preserve that privilege, counsel must provide advice rather than be engaged in compliance at an operational level.

For similar reasons, the trade compliance function may not be suite to cohabitate with the internal audit function. The internal audit role is to assist the audit committee and the

outside auditors in preserving shareholder value. To accomplish that goal, a significant degree of independence from the operational functions is required. On the other hand, there is no question that responsibility for the periodic review of the company's trade compliance internal controls should be vested in the internal audit function.

Many favor housing trade compliance under Tax. Others favor Finance. Few favor Logistics. In the end, each company must make its own decision bearing in mind the new responsibilities arising out of Sarbanes-Oxley.

For more details about this and other trade compliance topics, feel free to contact us at:

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