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Final "Audit Committee Financial Expert" Disclosure Rules, pursuant to Section 407 of the Sarbanes-Oxley Act of 2002

Summary

The Securities Exchange Commission has issued final rules under Section 407 of the Sarbanes-Oxley Act of 2002.[1] The rules require a public company to disclose in its annual report on Form 10-K or other applicable form whether there is at least one "audit committee financial expert" on its audit committee. If there is, then the company must disclose the name of the expert and whether the expert is "independent." A company that does not have such an expert is required to disclose that fact and explain why it does not.

Compliance Timing

Companies other than small business issuers are required to make the disclosures in their annual reports for fiscal years ending on or after July 15, 2003; small business issuers for fiscal years ending on or after December 15, 2003. This means that companies with fiscal years ending on December 31st will not be required to make this disclosure until their annual reports for the year ended December 31, 2003.

Disclosure Requirements

Under the new rules, the Board of Directors of every public company must determine whether or not at least one of the members of its audit committee is an "audit committee financial expert." The company must then disclose in its annual report[2] either that it has at least one audit committee financial expert on its audit committee or that it does not.

If the company has an audit committee financial expert, then it must disclose the name of the expert and whether the expert is "independent" in the meaning of Item 7(d)(3)(iv) of Schedule 14A under the Exchange Act.[3] This section of Schedule 14A refers to the definitions of independence contained in the listing standards applicable to the company. If the company's securities are not listed, then the company must use the definition in the rules of any registered national exchange or national securities association (e.g. NYSE, AMEX or Nasdaq). A company that does not have at least one audit committee financial expert must

[1] *See* Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Release No. 33-8177 (January 23, 2003).

[2] Companies reporting on Form 10-K may incorporate the disclosure by reference to a proxy or information statement containing the disclosure that is filed within 120 days after the end of the applicable fiscal year.

[3] This section of Schedule 14A was recently amended by SEC rules implementing the requirements of Section 301 of the Sarbanes-Oxley Act. See Standards Relating to Listed Company Audit Committees, Release No. 33-8220 (April 25, 2003). Among other things, these rules require the NYSE, AMEX and Nasdaq to adopt listing standards requiring that all members of a listed company's audit committee are independent.

disclose why it does not.

If the Board of a company determines that it has more than one audit committee financial expert, the company does not need to disclose this fact, but is permitted to do so. If the company chooses to disclose that it has more than one audit committee financial expert, then it must also disclose whether each such expert is "independent." There is no requirement that a company determine whether it has more than one audit committee financial expert.

Definition of Audit Committee Financial Expert

In order to determine that a person is an "audit committee financial expert," the Board must find that the person possesses all five of the attributes listed below, and that the person has acquired those attributes through one or more of the four means also listed below.

Attributes. The five required attributes of an "audit committee financial expert" are:

(i) An understanding of generally accepted accounting principles and financial statements;

(ii) The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;

(iii) Experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;

(iv) An understanding of internal controls and procedures for financial reporting; and

(v) An understanding of audit committee functions.

Means of Acquiring Attributes. The person must have acquired the above attributes through one or more of the following means:

(i) 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;

(ii) Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant,

auditor or person performing similar functions;

(iii) Experience overseeing or assessing the performance of companies or public accountants with respect to preparation, auditing or evaluation of financial statements; or

(iv) Other relevant experience.

Commission Commentary on the Definition

In its commentary on the originally proposed rules,[4] the Commission noted that it did not intend to provide a bright-line set of characteristics, but a set of somewhat subjective standards. Accordingly, where a question arises, it may be necessary to consider the question in light of the overall purpose of the rules and the additional guidance that the Commission has provided in its commentary on both the proposed rules and the final rules. The following is summary of the most important aspects of this guidance.

Purpose of Requirement. On several occasions in their commentary, the Commission has alluded to the overall purpose of having an audit committee financial expert. While the disclosure requirement is, of course, a direct result of the Sarbanes-Oxley Act of 2002, passed with the intention of preventing the kinds of problems perceived in recent corporate scandals, the Commission has expressed a view that an audit committee financial expert would be a person who is able to provide guidance to the audit committee and the company to prevent such problems from arising.

Having an audit committee financial expert is a way to ensure that at least one person on a company's audit committee will have the ability to view financial statements with a healthy dose of skepticism and to question management and auditors diligently and zealously. In other words, with the assistance of such a person, the audit committee will be able to ensure that (i) the financial statements of the company fairly present the financial condition, results of operations and cash flows of the company in accordance with generally accepted accounting principles and (ii) the financial statements and other financial information, taken together, fairly present the financial condition, results of operations and cash flows of the company.

Commentary on Certain Attributes. The commission provided commentary explaining several of the five attributes of an audit committee financial expert. This commentary is summarized below.

Attribute (ii). *"The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves."*

[4] *See* Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002, Release No. 33-8138 (October 22, 2002).

In explaining the changes made between the proposed provision and this final provision, the Commission commented that attribute (ii) does not require the audit committee financial expert to have experience in the same industry as the disclosing company, but the general ability required will ensure that the audit committee financial expert has the necessary background to assist the audit committee when addressing more detailed industry-specific standards or other particular topics. Experience with these detailed standards or topics is not necessary.

Attribute (iii). "*Experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities.*"

The Commission has stated that attribute (iii) captures the intent of Sarbanes-Oxley that the financial expert must have experience actually working directly and closely with financial statements in a way that provides familiarity with the contents of financial statements and the processes behind them. Thus, to satisfy this requirement, a person may have experience in any position that requires them to inspect financial statements with a healthy dose of skepticism and would enable them to question management and auditors diligently and zealously. In addition to people who have actual experience preparing and auditing financial statements, the Commission has stated that people in other industries who are required to analyze or evaluate financial statements may also be qualified. The Commission lists investment banking, venture capital investment and professional financial analysis as examples of industries where a person might acquire the necessary skills.

The Commission has stated that the focus should be on the breadth and level of complexity of the accounting issues with which the person has had experience. In making its assessment, the Board should focus on a variety of factors such as the size of the company with which the person has experience, the scope of that company's operations and the complexity of its financial statements and accounting. The Commission offers as an example, a person who had experience at a non-public company that was nevertheless required (e.g. by loan contracts) to create financial statements of similar complexity and in compliance with GAAP.

"Active Supervision" and Experience of CEOs. The Commission cautions companies that the experience of a principal executive officer "supervising" the chief financial officer, auditors, and others in a company "engaged in such activities" as described in attribute (iii) would not necessarily be the kind of supervision required. The term "active supervision" requires more than a traditional hierarchical relationship and means that the person participates in and contributes to, the process of addressing, albeit at a supervisory level, the same general types of issues regarding preparation, auditing, analysis or

evaluation of financial statements as those addressed by the person or persons being supervised. The supervisor should have experience that has contributed to the general expertise necessary to prepare, audit, analyze or evaluate financial statements that is at least comparable to the general expertise of those being supervised.

Attribute (iv). *"An understanding of internal controls and procedures for financial reporting."*

The Commission has said that a financial expert must be able to understand the purpose for and evaluate the effectiveness of a company's internal controls and procedures. The person should understand why the internal controls and procedures exist, how they were developed and how they operate.

Commentary on the Means of Acquiring Attributes. The Commission's commentary focuses on the third and fourth "means" listed in the definition of an audit committee financial expert.

Third Means. *"Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements."* According to the Commission, this provision was added to the final definition because of the Commission's view that certain individuals serving in governmental, self-regulatory and private-sector bodies overseeing the banking, insurance and securities industries work on issues related to financial statements on a regular basis and that such experience can constitute a very useful background for an audit committee financial expert.

Fourth Means. *"Other relevant experience."* By including this provision in the final rule, the Commission recognizes that the required attributes may be acquired in many different ways. However, the Commission also states that expertise must be the product of experience and not merely education. If the Board relies on "other relevant experience," then the company's disclosure must briefly list that experience.

In considering whether it can rely on "other relevant experience" a company may wish to consider the discussion above regarding the purpose of the requirements. For example, does the experience require the person to inspect financial statements with a healthy dose of skepticism and would it enable them to question management and auditors diligently and zealously?

Experience Serving on Audit Committee. Companies should note that the Commission would not view previous experience serving on an audit committee to, by itself, justify "grandfathering" a person as an audit committee financial expert.

Comparison with SRO Requirements. In compliance with NYSE or NASD

listing rules, many companies already have a financial expert as defined by those rules. The Commission has cautioned that the definition of "audit committee financial expert" is more rigorous than the NYSE and NASD definitions, and that a person meeting the requirements of the NYSE or NASD rules would not necessarily meet the requirements of the Commission's new rules.

The Totality of Factors. The Commission states that the Board of Directors should consider the totality of factors related to the proposed expert's experience. So experience as a public accountant or auditor, or a principal financial officer, controller or principal accounting officer would not by itself justify the Board of Directors of a company in deeming a person an audit committee financial expert. In addition to determining that the person has the requisite knowledge and experience, the Board should also find that the audit committee financial expert embodies "the highest standards of personal and professional integrity." Accordingly, the Commission states that the Board should consider any disciplinary actions that the person is or has been subject to.

All of these statements by the Commission suggest that the Board should do more than simply look to see if all of the elements are met, but give overall consideration to whether the person designated as an audit committee financial expert is a capable and appropriate person to serve the role that the Commission expects such a person to serve; i.e. a person of good character with the necessary knowledge and experience to understand accounting issues and spot problems, and a track record that indicates that they will be an aggressive advocate and watchdog for the interests of the corporation, thereby significantly reducing the possibility of the corporation engaging in the kinds of accounting activities that are the subject of recent scandals.

Safe Harbor Provision for Audit Committee Financial Experts.

According to the Commission, several comments to the proposed rules indicated a concern that a director named as an "audit committee financial expert" could inappropriately be subjected to a higher standard of care and increased liability with respect to audit committee decisions. To address this concern, the final rule adopts a safe harbor that provides:

- A person who is determined to be an audit committee financial expert will not be deemed an "expert" for any purpose, including without limitation for purposes of Section 11 of the Securities Act of 1933 (15 U.S.C. 77k), as a result of being designated or identified as an audit committee financial expert.

- The designation or identification of a person as an audit committee financial expert does not impose on such person any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such person as a member of the audit committee and Board of Directors in the absence of

such designation or identification.

- The designation or identification of a person as an audit committee financial expert does not affect the duties, obligations or liability of any other member of the audit committee or Board of Directors.

In addition to adopting the above safe harbor provisions, the Commission states its view that it would adversely affect the operation of the audit committee and its vital role in the financial reporting and public disclosure system, and corporate governance system generally, if courts were to conclude that the designation and public identification of an audit committee financial expert affected such person's duties, obligations or liability as an audit committee member or Board member. Accordingly, designation of a person as an audit committee financial expert should not increase (or decrease) that person's due diligence duties or liability beyond what would be required if they were not so designated.

This document is intended as in informational reminder and does not constitute legal advice. If you have any questions or would like to discuss a particular situation, you should contact your usual W & D attorney or one of us.

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