



February 2003

SEC ADOPTS RULES REQUIRING DISCLOSURE OF AUDIT COMMITTEE FINANCIAL EXPERT

On January 15, 2003, the SEC adopted rules implementing Section 407 (the "Final Rules") of the Sarbanes-Oxley Act of 2002 (the "Act"), which requires public companies to disclose whether or not they have at least one "financial expert" serving on their audit committees.[fn1]

The Final Rules require public companies to disclose whether they have at least one "audit committee financial expert" serving on their audit committees and, if so, the name of the expert and whether the expert is independent of management. The Final Rules are disclosure rules and do not require public company audit committees to have one member that is an audit committee financial expert. However, companies that do not have an audit committee financial expert serving on their audit committees must disclose that fact and explain why they have no such expert.

Timeline for Compliance

Recognizing the negative publicity that may result from a company having to disclose that it does not currently have an audit committee financial expert serving on its audit committee, the SEC provided for a limited transition period for compliance with the Final Rules. Public companies, other than small business issuers, must comply with the Final Rules beginning with their annual reports for fiscal years ending on or after July 15, 2003. Small business issuers must comply with the Final Rules beginning with their annual reports for fiscal years ending on or after December 15, 2003.

Required Disclosures Pertaining to Audit Committee Financial Experts

Section 407 of the Act relates to a reporting company's disclosure of whether at least one member of its audit committee is a "financial expert." However, the Final Rules refer to a company's "audit committee financial expert." The Release notes that the term "financial" traditionally extend beyond accounting and auditing to a company's capital structure, valuation, cash flows, risk analysis and capital-raising activities. The SEC chose the phrase "audit committee financial expert" because it

¹ See Release Nos. 33-8177, 34-47235 (the "Release"). The Release also includes the SEC's final rules related to Section 406 (relating to the adoption of a code of ethics for senior financial officers). Please refer to our website at www.mofo.com for client alerts relating to these final rules. The SEC indicated in the Release that it will implement final rules under Sections 406 and 407 as they pertain to registered investment companies in a subsequent release, in conjunction with their consideration of the adoption of proposed Form N-CSR.

more accurately reflects the characteristics particularly relevant to the functions of the audit committee – oversight, expertise in accounting matters as well as understanding of financial statements and the capacity to ask insightful questions to determine the completeness and accuracy of the company’s financial statements.

The Final Rules, codified at Item 401(h) of Regulation S-K and Item 401(e) of Regulation S-B, apply to public companies that file reports with the SEC, whether or not their securities are traded on a stock exchange or Nasdaq. The Final Rules require the following:

- The company’s board of directors must determine whether the company has at least one audit committee financial expert serving on its audit committee.
- If the company’s board of directors determines that the company has at least one audit committee financial expert serving on its audit committee, the company must disclose that fact and disclose the name or names of such audit committee financial experts and whether they are independent of the company’s management, as defined in Item 7(d)(3)(iv) of Schedule 14A under the Securities Exchange Act of 1934, as amended (the “Exchange Act”).
- If the company’s board of directors determined that the company does not have at least one audit committee financial expert serving on its audit committee, the company must disclose that fact and explain why.

The Final Rules require companies to include the required disclosures in their annual reports and do not require the disclosures to appear under a specific heading. A U.S. company may voluntarily choose to include this disclosure in its proxy or information statement and then incorporate the information by reference into its annual report (provided that it files the proxy or information statement with the SEC no later than 120 days after the end of the relevant fiscal year.)

Definition of “Audit Committee Financial Expert”

The Final Rules define an “audit committee financial expert” as a person with all of the five following attributes:

- An understanding of generally accepted accounting principles and financial statements;
- The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
- 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;

M O R R I S O N & F O E R S T E R L L P

- An understanding of internal controls and procedures for financial reporting; and
- An understanding of audit committee functions.

Under the Final Rules, in order to qualify as an “audit committee financial expert” a person must have acquired the above listed attributes through any one or more of the following:

- 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;
- Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar 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; and, if other relevant experience is what qualifies the director, that experience must be described.

The definition, as adopted, was revised considerably from that proposed by the SEC, in response to comments that the proposed definition was too restrictive and narrower than is required by the Act. Several commenters expressed concern that companies, in particular smaller ones, would have difficulty attracting persons with the required level of expertise or that companies would have to compromise their board selection process by nominating someone who the company does not believe is otherwise suitable for the position. The resulting changes, and their discussion in the Release, provide guidance that may be useful to directors when determining a person’s status as an audit committee financial expert.

In particular, it is noteworthy that candidates are not required to have direct experience applying estimates, accruals and reserves that are generally comparable to those used in the particular company’s financial statements as was originally proposed. Instead, so as not to limit the pool of acceptable candidates, the Final Rules focus on the ability to assess the general application of generally accepted accounting principles in connection with the accounting for estimates, accruals and reserves. The SEC also did not include the proposed non-exclusive list of factors that a board was required to consider in assessing candidates, stating that a board should focus on all the available facts and circumstances.

The final definition was also broadened to allow expertise to be gained through analyzing or evaluating financial statements and not merely through preparing or auditing them. Persons who actively supervise others engaged in those activities may also satisfy this prong of the definition. Similarly, while previous direct experience establishing or evaluating a company’s internal controls and procedures for financial reporting can contribute to a person’s understanding of these matters, such previous direct experience is not a required attribute of an audit committee financial expert. Rather, the board must determine that the candidate “understands the purpose” and is “able to evaluate the effectiveness” of such controls and procedures.

The proposed definition was also modified to address commenters' concerns regarding the anti-competitive impact of requiring an audit committee financial expert to have experience with accounting issues "generally comparable" to those raised by the company's financial statements. Commenters had argued that the requirement may be interpreted to mean that a financial expert would need prior experience with financial statements of other companies in the same industry. To address this concern, the SEC provided for a less restrictive version of the requirement. The Release points out that it is not necessary to have prior experience with financial statements in the same industry. Instead, the Final Rules require prior experience with financial statements that present a breadth and level of complexity of accounting issues generally comparable to those that can reasonably be expected to be raised by the company's financial statements. The SEC explained that experience with "generally comparable" issues should involve another company that, when focusing on such factors as size, scope of operations and complexity of accounting, faces comparable accounting issues.

An audit committee financial expert need not have obtained the required attributes through experience with public companies, as many private companies are contractually required to report GAAP-compliant financial results.

Determination of Audit Committee Financial Expert

The board of directors of every company subject to the Final Rules is now required to determine whether or not it has at least one audit committee financial expert serving on its audit committee. The Final Rules do not specify the date upon which the determination must be made. However, since the disclosure is required to be made in a company's annual report, presumably the determination of the existence of an audit committee financial expert should be as of the latest practicable date prior to filing the report.^[fn2]

The Final Rules permit, but do not require, a company to disclose that it has more than one audit committee financial expert on its audit committee. Similarly, once a company's board determines that a particular audit committee member qualifies as an audit committee financial expert, the board may, but is not required to, determine whether additional audit committee members also qualify as experts.

Notably, the definition allows directors to conclude that a person is an audit committee financial expert if, instead of obtaining the required attributes through one of the specific roles identified, the person has "other relevant experience." If the board makes such a determination, it is required to briefly list that person's experience. However, the SEC rejected any notion of "grandfathering" a person as an audit committee financial expert on the sole basis that he or she previously served on an audit committee or that he or she has experience as a public accountant, principal financial officer or one of the other roles mentioned in the definition. In this regard, the SEC stressed the requirement that the board determine that its audit committee financial expert has the relevant knowledge and experience and, moreover, embodies the highest standards of personal and professional integrity. The SEC noted that the board should consider in particular any disciplinary actions to which a candidate is, or has been, subject.

The Release makes clear that the new disclosure requirements are not satisfied if the company discloses that its board of directors has decided not to make a

² See, General Instruction C to Form 10-K.

determination as to whether it has an audit committee financial expert. Furthermore, if the company's board determines that at least one of the audit committee members qualifies as an expert, the company must accurately disclose this fact. A company may not disclose that it does not have an audit committee financial expert if its board of directors has determined that such an expert serves on the audit committee.

A board also cannot satisfy the requirement by disclosing that the audit committee members collectively possess the necessary qualifications of an audit committee financial expert. However, if a company does not have an audit committee financial expert, after disclosing that fact it may explain aspects of the definition that are satisfied by various audit committee members.

Safe Harbor for Financial Experts

Many commenters expressed concern that the requirement that companies identify the audit committee financial expert may result in imposing greater duties and potential liabilities on that individual. In an effort to alleviate those concerns, the SEC incorporated a safe harbor into the Final Rules clarifying that:

- a person who is determined to be an audit committee financial expert will not be deemed an "expert" for any purpose (including for purposes of Section 11 of the Securities Act of 1933 (the "Securities Act")) as a result of the determination and he or she is not subject to a higher level of due diligence with respect to any portion of a registration filed under the Securities Act;
- the new disclosure requirements do not impose on the audit committee financial expert any duties, obligations or liability that are greater than the duties, obligation and liability imposed on such person as a member of the audit committee and board of directors in the absence of such designation; and
- the new disclosure requirements do not affect the duties, obligations or liability of any other member of the audit committee or board of directors.

Different Definitions Used by the NYSE and Nasdaq

The definition of "audit committee financial expert" in the Final Rules is substantially different from the standards of the NYSE and Nasdaq with respect to financial literacy and expertise.^[fn3]

NYSE. The NYSE currently requires that each member of an audit committee be financially literate, as such qualification is interpreted by the Board of Directors in its business judgment, or must become financially literate within a reasonable period of time after his or her appointment to the audit committee. In addition, at least one member of the audit committee must have accounting or related financial

³ For additional comparative information, please see our August 2002 update, "NYSE Adopts Changes to its Corporate Governance and Listing Standards; Differences between Current NYSE and Nasdaq Proposals and Sarbanes-Oxley Act Requirements."

management expertise, as the Board of Directors interprets such qualification in its business judgment.[fn4]

Nasdaq. Nasdaq currently requires that each member of an audit committee be able to read and understand fundamental financial statements, including a balance sheet, income statement, and cash flow statement, or will become able to do so within a reasonable period of time after his or her appointment to the committee. Nasdaq has proposed rules subject to approval by the SEC that would require audit committee members to have such expertise at the time of their appointment. Additionally, Nasdaq requires that at least one member of the audit committee have past employment experience in finance or accounting, professional certification in accounting, or any other comparable experience or background which results in his or her financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.[fn5]

The NYSE and Nasdaq are expected to revise several of their corporate governance rules to conform to the Final Rules.

Disclosure of Independence

The Final Rules require reporting companies to disclose whether the audit committee financial expert is “independent” of management. Although the Act requires all reporting companies, following adoption of applicable SRO rules, to have all-independent audit committees, the SEC noted in the Release that not all reporting companies are listed companies and therefore subject to SRO independence requirements. For that reason, the SEC felt it was important to require disclosure regarding the independence of the audit committee financial expert.

The definition of “independent” to be used with respect to the audit committee financial expert is the definition of “independent” used Item 7(d)(3)(iv) of Schedule 14A. That item of the proxy rules incorporates the independence definition under the corporate governance regulations of the reporting companies’ applicable SROs. If the reporting company is not listed on Nasdaq or a national securities exchange, the company must choose a definition of “independent” used by Nasdaq or one of the national securities exchanges.

NYSE. The NYSE has proposed rules, awaiting approval by the SEC, that would impose additional requirements for an audit committee member to be deemed independent. No audit committee member would be deemed independent unless the Board of Directors affirmatively determined that the member had no material relationship with the company, either directly or as a partner, shareholder or officer of an organization that has a relationship with the company. In addition, under the NYSE’s proposed rules, the following persons would not be considered independent:

- former employees of the company (until five years after the employment relationship has ended);

⁴ See NYSE Rule 303.01.

⁵ See Nasdaq Rule 4350(d)(2).

M O R R I S O N & F O E R S T E R L L P

- persons presently or formerly affiliated with, or employed by, a present or former auditor of the company or an affiliate (until five years after the affiliation or auditing relationship has ended); and
- persons who are, or in the past five years have been, part of an interlocking directorate in which the CEO or another executive officer of the company serves on the compensation committee of another corporation that employs any such person.

In addition, a person who is an “immediate family member” of someone who would not be independent as a result of these provisions would also not be deemed independent under the NYSE’s proposed rules.

Nasdaq. Nasdaq also proposed rules, subject to SEC approval, that provide detailed guidance as to its independence requirements. Under Nasdaq’s proposed rules, the following types of directors will not be deemed to be independent, and therefore, would not be permitted to be a member of the audit committee:

- a director who is employed by the company or any of its affiliates during the current year or any of the past three years;
- a director who accepts any accept directly or indirectly any consulting, advisory or other compensatory fee from the company;
- a director who is a family member of an individual who is, or has been in any of the past three years, employed by the company or any of its affiliates as an executive officer;
- a director who is a partner in, or a controlling shareholder or an executive officer of, any organization (including charitable organizations) to which the company made, or from which the company received, payments (other than those arising solely from investments in the company’s securities) that exceed 5% of the company’s or such organization’s consolidated gross revenues for that year, or \$200,000, whichever is more, during any of the past three years;
- a director who is employed, or who was employed during any of the three previous years, as an executive of another entity where any of the company’s executives serve on that entity’s compensation committee;
- a 20% or greater shareholder of the company; and
- for a three-year period following their employment, former partners or employees of the company’s auditors.

Nasdaq currently permits one non-independent director to serve as a member of the audit committee under exceptional circumstances. Under the proposed Nasdaq rules, a company must limit the time that such director may serve on the audit committee to two years, and such person would be prohibited from serving as the chairperson of the audit committee.

Special Concerns Applicable to Foreign Private Issuers

In the case of foreign private issuers, the SEC provides that the phrase “generally accepted accounting principles” used in the definition of audit committee financial expert should be deemed to mean generally accepted accounting principles used by the foreign private issuer in preparing its primary financial statements filed with the SEC. The SEC was sensitive to the fact that requiring an audit committee financial expert to possess expertise relating to U.S. generally accepted accounting principles could burden foreign private issuers who use home country accounting principles or international accounting standards to prepare their primary financial statements, emphasizing that the proper focus of audit committee financial expertise is on the principles used to prepare the company’s primary financial statements filed with the SEC. The Final Rules also acknowledged the two-tiered board structure of many foreign private issuers and included an instruction providing that the use of the phrase “board of directors” with respect to foreign private issuers means the supervisory or non-management board.

Potential Impact of the Rule

The Final Rules are disclosure rules only, and do not, in and of themselves, require an audit committee to have any particular composition. In addition to the Final Rules, companies that are listed on the NYSE or Nasdaq will need to comply with the audit committee financial sophistication requirements that will be set forth in their respective listing requirements. We anticipate that many reporting companies will want to avoid disclosing that they do not have at least one financial expert on their audit committees because of the negative publicity that might result. Accordingly, it is important that all public companies and their boards begin assessing the qualifications of their audit committee members under the Final Rules.