

## SEC Adopts Final Rules About Audit Committee Financial Experts

The SEC recently adopted new rules that require a company to disclose annually whether its audit committee includes at least one member who is an “audit committee financial expert,” as defined in the new rules. New Item 401(h) of Regulation S-K will also require a registrant to disclose the identity of such expert, and whether he or she is independent of management. Companies must comply with these new disclosure requirements in annual reports for fiscal years ending on or after July 15, 2003 (December 15, 2003 in the case of small business issuers). A summary of the new rules follows.

### Disclosure Requirements

- A company must disclose in its Annual Report on Form 10-K<sup>1</sup>:
  - whether or not the board has determined that there is at least one “audit committee financial expert” serving on its audit committee, and
  - if so, the name of one expert and whether the expert is independent of management.
- Any company that does not have an audit committee financial expert must disclose that fact and explain why.
- The board must determine whether an individual is an audit committee financial expert (using factors discussed in more detail below) and whether the expert is independent.
- For companies that file annual reports on Form 10-K, the test for “independence” looks to Item 7(d)(3)(iv) of Schedule 14A of the proxy rules under the Exchange Act. This definition tracks the listing standards of the NYSE, AMEX or NASD as they apply to the company.<sup>2</sup> Companies whose securities are not listed on the NYSE or AMEX or quoted on NASDAQ must pick the definition found in one of these three listing standards and state which definition was used.
- A company may, but is not required to, disclose if it has more than one audit committee financial expert and the names of those additional experts.

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<sup>1</sup> Because this information will appear in Part III of these forms, it will also be possible to make these new disclosures by incorporating by reference from a company’s definitive proxy statement or information statement if the company chooses to include that information in its proxy statement or information statement.

<sup>2</sup> Section 301 of the Sarbanes-Oxley Act of 2002 requires the SEC to enact rules requiring all audit committee members on companies listed on a national exchange to be independent. Accordingly, the definition under current listing standards is expected to be changed by SEC rules to reflect the definition in Section 10A (m)(3) of the Exchange Act.

## Definition of “Audit Committee Financial Expert”

- The new rules define an “audit committee financial expert” as a person who has **all** of the following five 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 registrants’ financial statements, or experience actively supervising one or more persons engaged in such activities;
  - An understanding of internal controls and procedures for financial reporting; and
  - An understanding of audit committee functions.
- A person must have acquired such attributes through 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.
- “Active supervision,” as used above, means that an individual participates in, and contributes to, the process of addressing the same general types of issues regarding the preparation, auditing, analysis or evaluations of financial statements as those addressed by the individual(s) being supervised.
- The definition in the final rules is broader than that originally proposed, and is intended to include a larger pool of people who would qualify as audit committee financial experts.
- The final rules do not require a company to disclose the basis for the board’s determination that an individual has the requisite experience to be designated an audit committee financial expert. However, if the individual qualifies by virtue of having “other relevant experience,” the company’s disclosure must briefly list that person’s experience.

- Previous service on the audit committee will not, by itself, justify “grandfathering” that person as an audit committee financial expert.

### Safe Harbor

- Because of the concern expressed in many comment letters regarding that audit committee financial experts could be subject to increased liability, the final rules include a safe harbor from liability which states that:
  - A person who is determined to be an audit committee financial expert will not be deemed an “expert” for any purpose, including liability under Section 11 of the Securities Act;
  - The designation of a person as an audit committee financial expert does not impose any greater duties, obligations or liabilities on that person; and
  - The designation of a person as an audit committee financial expert does not affect the duties, obligations or liabilities of the other members of the audit committee or board.

### Who Must Disclose

- The new rules apply to all filings on Form 10-K, including those by companies that file 10-Ks under the Exchange Act in compliance with indenture requirements (so-called “voluntary debt filers”).
- The new disclosure requirements also apply to small business issuers filing on Form 10-KSB and to foreign private issuers filing on Form 20-F (or Form 40-F in the case of Canadian issuers).
- The proposing release specified that entities such as limited liability companies and limited partnerships that do not have oversight bodies similar to audit committees must disclose that their organizational structure does not provide for an audit committee.
- Asset-Backed Issuers are exempt from this disclosure requirement.

### Additional Considerations for Foreign Private Issuers

- Although the ability to reconcile a foreign issuer’s financial statements with U.S. GAAP should be considered in determining whether an individual is an audit committee financial expert, the release states that the main consideration should be the individual’s experience with and understanding of the GAAP used to prepare the company’s financial statements filed with the SEC.
- For foreign issuers with two-tiered boards, one of which is supervisory or nonmanagement, it is the non-management group that should determine whether someone is an audit committee financial expert.
- Foreign private issuers are not required to disclose whether audit committee financial experts are independent pending the final determination of the definition of “independent” under Section 301 of the Sarbanes-Oxley Act.

### **Effective Dates**

Companies must comply with the new disclosure requirements in annual reports for fiscal years ending on or after July 15, 2003. Small business issuers, however, have until fiscal years ending on or after December 15, 2003 to comply.

### **Contact Information**

If you have any questions or would like to learn more about the proposed rules, please contact the lawyer who normally represents you.