

### **AUDIT COMMITTEE FINANCIAL EXPERTS**

On January 23, 2003 the SEC released final rules under Section 407 of the Sarbanes-Oxley Act of 2002 regarding disclosures with respect to "audit committee financial experts." The final definition of audit committee financial expert adopted by the SEC is broader than the definition of "financial expert" initially proposed by the SEC. As a result, a larger universe of people will qualify as an audit committee financial expert under the final rules.

#### ***Executive Summary***

The rules require Exchange Act reporting companies to:

- Annually disclose whether or not its board of directors has at least one audit committee financial expert on its audit committee, and if so, the name of such expert and whether or not such expert is independent of management.
- If the company does not have an audit committee financial expert, explain why it does not have such an expert.
- Make such disclosures in the company's annual report, commencing with the annual report for the company's fiscal year ending on or after July 15, 2003 or, in the case of small business issuers, the annual report for the company's fiscal year ending on or after December 15, 2003.

The rules contain a safe-harbor to protect audit committee financial experts from enhanced liability, including liability under Section 11 of the Securities Act, as an "expert," and to clarify that designation as an audit committee financial expert does not impose duties, obligations or liabilities on the designated person that are any greater than those of any other member of an audit committee.

#### ***Practical Considerations***

In order to comply with the rules each reporting company should do the following:

- Its board of directors should evaluate the members of its audit committee to determine whether or not it has at least one member who qualifies as an audit committee financial expert and, if so, whether or not such person is independent of management.
- If the board determines that its audit committee does not have a member who qualifies as an audit committee financial expert and is independent of management, the board should consider whether or not any other member of the board who is independent of management qualifies as an audit committee financial expert. If so, the board should consider rearranging committee assignments to assign the person qualifying as an audit committee financial expert to the audit committee. If not, the board should consider recruiting an individual to serve on the audit committee who is independent of management and qualifies as an audit committee financial expert.
- If it does not have an audit committee financial expert, the company should consider disclosing, together with its explanation of why it does not have such an expert, any attributes of the audit committee financial expert definition that are satisfied by members of the company's audit committee and, if applicable, the audit committee's use of outside experts.

### ***What disclosures are required?***

Under the rules, a reporting company is required to annually disclose:

- whether or not it has at least one audit committee financial expert on its audit committee, and if so, the name of the audit committee financial expert and whether or not the expert is independent of management;
- if the company does not have an audit committee financial expert, an explanation of why not; and
- if a person qualifies as an audit committee financial expert by virtue of possessing "other relevant experience," a brief list of the person's experience.

### ***What if the audit committee does not have an audit committee financial expert?***

The company should evaluate whether or not a member of its audit committee meets the definition of audit committee financial expert set forth in the final rules. If it does not, it should consider recruiting one. While the rules do not allow companies to consider the collective expertise of the audit committee, if a company does not have one member that is an audit committee financial expert, it may disclose the fact that various members of the audit committee satisfy certain or all of the attributes of an audit committee financial expert. In addition, a company may consider disclosing the use of outside experts hired by the audit committee to assist the committee on specific matters.

### ***Where should this information be disclosed?***

Such information should be disclosed in the company's annual report. This disclosure is included in Part III of Forms 10-K and 10-KSB. This information will not need to be included in the quarterly reports. This information may also be incorporated by reference to the company's proxy statement, as long as the proxy is filed within 120 days of the end of the year covered by the annual report.

### ***When will a company first have to make this audit committee financial expert disclosure?***

Reporting companies must comply with the audit committee financial expert disclosure requirement in their annual reports for fiscal years ending on or after July 15, 2003. Small businesses must comply in their annual reports for fiscal years ending on or after December 15, 2003. As a result, all reporting companies that have a calendar fiscal year will be required to comply with the disclosure requirements no later than next year's proxy season.

### ***Who qualifies as an audit committee financial expert?***

An audit committee financial expert is defined as a person who has obtained **all** of the following attributes:

- an understanding of GAAP and financial statements;
- an 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;
- an understanding of internal controls and procedures for financial reporting; and
- an understanding of audit committee functions.

To qualify, the audit committee financial expert would have acquired the attributes listed above through any one or more of the following means:

- 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.

***Why do the rules refer to an audit committee financial expert rather than a financial expert, the term used in the Sarbanes-Oxley Act?***

Section 407 of the Sarbanes-Oxley Act of 2002 requires the SEC to issue rules requiring each reporting company to disclose whether or not (and, if not, an explanation of why not) its audit committee has at least one financial expert as defined by the SEC's rules. In the final rules, the SEC uses the term "audit committee financial expert" rather than the term "financial expert" because the term audit committee financial expert more pointedly suggests "the characteristics that are particularly relevant to the functions of the audit committee, such as: a thorough understanding of the audit committee's oversight role, expertise in accounting matters as well as understanding of financial statements, and the ability to ask the right questions to determine whether the company's financial statements are complete and accurate."

***Who determines whether or not a person qualifies as an audit committee financial expert and on what basis is such determination made?***

A company's board of directors should determine whether or not a person qualifies as an audit committee financial expert. The board should consider all of the facts and circumstances surrounding the person's qualifications, including the person's personal and professional integrity and the breadth and level of the person's education, service in relevant positions and duties in such positions, experience and familiarity with financial statements, past experience on audit committees and other relevant experiences. The proposed rules contained a list of qualitative factors (that are not included in the final rules) to be considered in evaluating whether or not a person qualifies as an audit committee financial expert. Although such factors were not intended as an exhaustive list of factors and are not included in the final rules, they provide good guidance for the types of factors that should be taken into account in determining whether or not a person qualifies as an audit committee financial expert.

***Must an audit committee financial expert have experience preparing or auditing financial statements?***

No. Under the final rules an audit committee financial expert may have experience **preparing** or **auditing** financial statements (such as experience as a chief financial officer, controller, accountant or auditor), experience **analyzing** or **evaluating** financial statements (such as experience in investment banking or venture capital or as a financial analyst) or experience **actively supervising** others engaged in preparing, auditing, analyzing or evaluating financial statements. The key concept is that "[a]n audit committee 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." Actively supervising does not simply refer to a reporting relationship. It means, in a supervisory role, participating in and contributing to the process of preparing, auditing, analyzing or evaluating financial statements and assessing accounting issues in a manner that demonstrates general expertise at least comparable to the general expertise of those being supervised. In addition, such experience may have been obtained overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements (such as in the case of individuals who work for governmental agencies and self-regulatory and other private-sector organizations that provide oversight to the banking, insurance and securities industries and are involved on a regular basis with issues related to financial statements).

***Must an audit committee financial expert have experience in the company's industry or with an Exchange Act reporting company?***

No. An audit committee financial expert must have experience with financial statements that present accounting issues that are generally comparable to the breadth and complexity of those that can reasonably be expected to be raised by the company's financial statements. In determining whether or not a person satisfies this criteria,

the board of directors of a company should consider 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.

***Must an audit committee financial expert have experience establishing or implementing internal controls and procedures for financial reporting?***

No. An audit committee financial expert must have an **understanding** of internal controls and procedures for financial reporting. That is, such person must understand the purpose for such controls and procedures and how they operate and be able to evaluate their effectiveness.

***Will audit committee financial experts be subject to enhanced liability?***

The rules provide a safe harbor for individuals identified by reporting companies as audit committee financial experts. Under the rules, an audit committee financial expert will not be deemed to be an "expert" for any purpose, including for purposes of Section 11 of the Securities Act of 1933. Further, the designation of any person as an audit committee financial expert does not impose any additional duties, obligations or liabilities on that person that are greater than those imposed on members of the audit committee in the absence of this designation. Finally, the designation of an audit committee financial expert on the audit committee does not affect the duties, obligations or liability of any other member of the audit committee or board of directors. Although the safe harbor exists under the rules, it does not eliminate or alter the general responsibility of all members of the board of directors to protect the interests of the shareholders of the company and to properly assess all matters before acting on them set forth under applicable state law.

**Endnotes**

- <sup>1</sup> SEC Release Nos. 33-8177; 34-47235, available at [www.sec.gov/rules/final/33-8177.htm](http://www.sec.gov/rules/final/33-8177.htm). The SEC extended the applicability of these rules to Management Investment Companies on January 27, 2003 in SEC Release Nos. 34-47262; IC-25914, available at [www.sec.gov/rules/final/34-47262.htm](http://www.sec.gov/rules/final/34-47262.htm).
- <sup>2</sup> The rules contemplate that the SEC will use a consistent definition of independence for corporate governance purposes. Section 301 of the Sarbanes-Oxley Act of 2002 amended the Exchange Act to include a definition of "independence." In order to be considered independent, an audit committee member may not, other than as a member of the audit committee, the board of directors or any other committee, (i) accept any consulting, advisory or other compensatory fee from the issuer; or (ii) be an affiliated person of the issuer or any subsidiary thereof. The SEC has issued a proposed definition of the term "affiliate" in this context. The final rules regarding Management Investment Companies provide a different definition of "independence." In order to be considered independent, a member of an audit committee of a registered management investment company may not, other than as a member of the audit committee, the board of directors, or any other board committee: (i) accept directly or indirectly any consulting, advisory, or other compensatory fee from the issuer; or (ii) be an "interested person" of the investment company as defined in Section 2(a)(19) of the Investment Company Act.

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