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Client Alert

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SECURITIES LAW

Update on the Sarbanes-Oxley Act (Fifth in a Series): SEC Issues Proposed Rules on Audit Committee Financial Experts

Pursuant to the requirements of Section 407 of the Sarbanes-Oxley Act of 2002 (the "Act"), the Securities and Exchange Commission (SEC) recently issued a rule proposal (the "Release") that would require issuers to disclose in their annual reports the names and number of persons serving on their audit committees who could be considered "financial experts".¹ If an issuer's audit committee has no financial experts, it would be required to disclose the reasons why it does not.

The SEC suggests in the Release that Section 407 was included in the Act in response to recent corporate scandals which have, among other things, highlighted problems that can occur as a result of inadequate oversight of a company's financial statements and audit process by the board of directors and audit committee. The SEC's goal in implementing Section 407 is to provide investors with information to be able to assess the level of financial oversight and expertise on the audit committees of companies that are subject to the rules.

The rules would apply to all companies that are required to file reports under Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), including foreign private issuers and small business issuers. The rules would also apply to investment companies registered under the Investment Company Act of 1940.

Who would be considered to be a financial expert?

The Release includes a definition of who would be considered a "financial expert" and the criteria to be considered by the issuer's Board of Directors in making that determination. The SEC emphasized that the determination is fact-specific and declined to propose a bright-line test, leaving to the Board of Directors some level of discretion in making the determination.

Pursuant to the Release, a "financial expert" would mean a person who, through education and experience as a public accountant or auditor, principal financial officer, controller or principal accounting officer *of a public company*, or from a position involving the performance of similar functions:

- has an understanding of generally accepted accounting principles and financial statements,
- has experience applying such generally accepted accounting principles in connection with accounting for estimates, accruals and reserves that are generally comparable to the estimates, accruals and reserves that are used in the issuer's financial statements,
- has experience in preparing or auditing financial statements that present accounting issues that are generally comparable to those raised by the issuer's financial statements,

¹ Proposed Rule, "Disclosure Required by Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002," Release Nos. 33-8138; 34-46701; IC-25775, dated October 22, 2002. A full copy of the Release is available from the SEC's website at <http://www.sec.gov/rules/proposed/33-8138.htm>.

- has experience with internal accounting controls and procedures for financial reporting, and
- understands audit committee functions.

The SEC states in particular that it plans to require financial experts to have experience with the financial statements of Exchange Act reporting companies, and not just of privately-held entities. In addition, the SEC notes in the Release that other factors can and should be taken into consideration in determining who is a “financial expert,” as described in the following section.

Who must make the decision as to who is a “financial expert”?

The Board of Directors as a whole is responsible for making this determination. The SEC states in the Release that Boards of Directors must not adopt a “check-the-box” approach to determining whether someone is a financial expert, but rather must make a *qualitative* assessment of the experience and education of each audit committee member and take into account a variety of factors in making that assessment. Some of the factors that Boards should consider, among others, are the individual’s level of accounting or financial education, certifications (such as a CPA certificate or certificates issued by financial standards boards), past experience as a chief financial, controller or accounting officer, the level and amount of such experience, familiarity with the financial reporting requirements of the Exchange Act, and past and current membership on other public company audit committees. Simply possessing some or all of these attributes and those listed above, however, will not necessarily mean that a person is appropriate to be selected as a financial expert.

In addition, with respect to the experience component of the above test, the SEC notes in the Release that a Board of Directors may conclude that a person qualifies as a financial expert even if he or she does not have experience serving as a public accountant or auditor, principal financial officer, controller or principal accounting officer of a public company, or has not held a position involving the performance of similar functions, if the Board is able to conclude that the person has achieved similar expertise and experience. If a Board makes such a determination, however, it would have to disclose the basis and reasoning for that conclusion in its annual report. The Boards of foreign private issuers should also consider the individual’s experience

with generally accepted accounting principles in the issuer’s home country and experience with reconciliation to U.S. GAAP.

How might this rule require us to change our audit committee?

In the Release, the SEC refers to the existing listing standards of The Nasdaq Stock Market, Inc. (“Nasdaq”) and the New York Stock Exchange, Inc. (“NYSE”), each of which currently requires some level of financial expertise among the members of listed companies’ audit committees.

Specifically, Nasdaq currently requires that each member of the audit committee be able to read and understand fundamental financial statements, including a company’s balance sheet, income statement, and cash flow statement, or become able to do so within a reasonable period of time after his or her appointment to the audit committee, and that at least one member of the audit committee have past employment experience in finance or accounting, a professional certification in accounting, or comparable experience or background resulting 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.

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

The SEC notes that the attributes required to be a “financial expert” under Section 407 of the Act and the SEC’s proposed rules “are more detailed and rigorous than those reflected” in Nasdaq’s and the NYSE’s current rules, and thus “it is possible that a person who previously qualified as a financial expert under the broader guidelines... may not have sufficient expertise and experience” to qualify as a financial expert under the new rules. Accordingly, companies should begin the process now of evaluating the members of their audit committees to determine whether any members meet the proposed requirements.

What would designation as a “financial expert” mean for a director so designated?

The SEC notes in the Release that “the primary benefit of having a financial expert serving on a company’s audit committee is that the person, with his or her enhanced level of financial sophistication or expertise, can serve as a resource for the audit committee as a whole in carrying out its functions.” The financial expert would be called upon to assist the audit committee in overseeing the audit process, but not to audit the company or its financial statements. The SEC states that it does not intend to impose a higher degree of individual responsibility or obligation on audit committee members designated as “financial experts,” nor does it intend for such persons to be considered “experts” for purposes of Section 11 liability under the Securities Act of 1933, as amended.

When and where must this information be disclosed?

The SEC proposes to require issuers to include this disclosure in each annual report on Form 10-K, Form 10-KSB, or Form 20-F, under a separately captioned section entitled “Audit Committee Financial Experts.” The SEC proposes to require the disclosure in Part III of the Form 10-K and Form 10-KSB, and would permit issuers to “forward-incorporate” the disclosure by reference to their annual meeting proxy statements, if filed within 120 days after the end of the fiscal year covered by the annual report.

Comments on the proposed rules are due by November 29, 2002. Pursuant to the directives in the Act, the SEC is required to issue final rules relating to this topic no later than January 26, 2003. Although the SEC did not specify this in the Release, members of the Staff of the SEC’s Division of Corporation Finance have indicated informally that the disclosure is likely to be required in annual reports filed for fiscal years ending on or after December 31, 2002.

Please contact the Mintz Levin attorney who handles your corporate and securities law matters if you have any questions regarding this information. We are continuing to monitor closely all developments relating to the Act and will notify our clients when the proposed rules become final.