



**FENWICK & WEST LLP**

*CORPORATE & SECURITIES LAW UPDATE*

## **SEC Proposes New Rules To Implement Provisions of the Sarbanes-Oxley Act Regarding Service of Financial Experts on Audit Committees, Codes of Ethics and Internal Controls**

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## **SEC Proposes New Rules To Implement Provisions of the Sarbanes-Oxley Act Regarding Service of Financial Experts on Audit Committees, Codes of Ethics and Internal Controls**

On October 22, 2002, the SEC issued proposed rules to implement Sections 404, 406 and 407 of the Sarbanes-Oxley Act of 2002. The complete text of these rules can be found at <http://www.sec.gov/rules/proposed/33-8138.htm>.

While these rules are only proposals at this point, we expect the SEC to adopt final rules relatively quickly after the 30-day comment period ends, and we expect the substance of the final rules to be largely the same as the proposed version.

The rule proposals affect public companies' disclosure in three separate areas:

- Disclosure about "financial experts" serving on the audit committee;
- Code of ethics; and
- Internal controls reports and auditor attestation of the report.

### **I. Proposed Rules Regarding Disclosure of Audit Committee Financial Expert(s)**

Section 407 of the Sarbanes-Oxley Act directed the SEC to issue rules requiring public companies to disclose whether their audit committees include any members who are financial experts - a term that Congress instructed the SEC to define in a manner consistent with criteria included in the Act.

#### **Who qualifies as a "financial expert" under the proposal?**

Under the SEC's proposal, a financial expert is a person who has developed the attributes listed below through:

- Education and experience as a public accountant or a senior financial officer of a public company;
- Experience in similar positions; or
- Experience that results, in the Board's view, in the person's having similar expertise and experience.

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All of the following attributes must be present for a person to qualify as a financial expert under the proposal:

- An understanding of GAAP and financial statements
- Experience applying GAAP in connection with accounting for estimates, accruals and reserves that are comparable to those used by the company;
- Experience preparing or auditing financial statements that present issues comparable to those raised by the company's financial statements;
- Experience with internal controls and procedures for financial reporting; and
- An understanding of audit committee functions.

**Who determines whether a person qualifies as a financial expert under this proposal?**

The Board of Directors would evaluate the members of the audit committee to determine which of them are financial experts. The Board would evaluate the totality of each person's education and experience with a view to determining whether it evidences the attributes required of a financial expert. The inquiry should include evaluation of a number of specified factors, including for each person his or her:

- Level of education in finance or accounting;
- Status as a CPA in good standing, and the amount of time spent actively practicing as a CPA;
- Status as a certified accounting or financial expert, and for how long;
- Service as a CFO, controller or principal accounting officer of a public company, and for how long;
- Specific duties of the person in his or her capacity as a public accountant, auditor, CFO, controller, principal accounting officer or similar position;
- Familiarity and experience with laws and regulations applicable to financial statements of public companies;
- Level and amount of direct experience preparing, reviewing, auditing or analyzing public company financial statements;
- Membership on a public company audit committee, past or current;
- Familiarity and experience using and analyzing financial statements of public companies; and
- Any other relevant qualifications that would assist the person in evaluating financial statements and other financial information and to make knowledgeable and thorough inquiries whether the financial statements fairly present, in accordance with GAAP and taken together with other financial information, the company's financial condition, operating results and cash flows.

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**Does the SEC recommend any particular number of financial experts?**

No, but if the company has no financial expert serving on its audit committee, it must disclose that fact and explain why it has none.

**Does a financial expert have any special liabilities?**

The SEC has stated that designating a person as a financial expert "should not impose a higher degree of individual responsibility or obligation on a member of the audit committee." The SEC also states that one audit committee member's status as a financial expert should not decrease the responsibilities or duties of other members. The primary benefit of having a financial expert serve on an audit committee is that he or she may serve as an additional resource for the committee. Nonetheless, it will remain to be seen whether financial experts will be subjected to more claims or held by courts to higher standards of performance.

**What would companies be required to disclose?**

Each public company would be required to disclose the number and names of the persons that its Board of Directors has determined to be the financial experts serving on the audit committee. It would also be required to disclose whether those financial experts are "independent" as defined in the Sarbanes-Oxley Act and, if not, the reasons they are not. In addition, if the Board determines that a person's experience from serving as something other than a public accountant, senior financial officer or similar position provides that person with similar expertise and experience, and determines that such person has the attributes of a financial expert, the company would be required to disclose the basis for that determination.

**Where would the required disclosure about financial experts be made under this proposal?**

The disclosure would be made in the issuer's Form 10-K or in a proxy statement relating to the election of directors that is filed by the company within 120 days of the end of its fiscal year.

## **II. Proposed Rules Regarding Code of Ethics Disclosure**

Section 406 of the Sarbanes-Oxley Act directed the SEC to issue rules requiring public companies to disclose whether they have adopted a code of ethics for senior financial officers, and if not, why not. The SEC has extended this requirement to include CEOs as well.

**What is a "code of ethics"?**

The proposed rule defines code of ethics to mean a codification of standards reasonably designed:

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- to deter wrongdoing, and
  - to promote:
    - Honest and ethical conduct, including ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
    - Avoidance of conflicts of interest, including disclosure to an appropriate person or persons identified in the ethics code of any material transaction or relationship that reasonably could be expected to give rise to such a conflict;
    - Full, fair, accurate, timely and understandable disclosure in the company's SEC filings and other public communications;
    - Compliance with applicable laws, rules and regulations;
    - Prompt internal reporting, to an appropriate person identified in the ethics code, of any code violations; and
    - Accountability for adherence to the ethics code.

**Would we publicly file our code of ethics?**

Yes. The ethics code would be required to be filed as an exhibit to a company's Form 10-K.

**What if we change our code of ethics? What if we grant an ethics code exception or waiver to someone or for some transaction?**

Under the SEC proposal, all changes to the code of ethics and all waivers of the code granted to the CEO, CFO, controller or principal accounting officer, and persons performing similar functions, would be required to be disclosed. Disclosure would have to be made on Form 8-K within two business days. Disclosure could instead be made within two business days on the company's website if the company discloses that intention and its Internet address in its most recent Form 10-K.

### **III. Proposed Rules Regarding Management's Quarterly and Annual Assessments of Internal Controls and its Annual Internal Controls Report, the Independent Auditors' Attestation, and Amendments to Rules on Disclosure Controls and Procedures**

Section 404 of the Sarbanes-Oxley Act directed the SEC to issue rules requiring public companies to report annually on management's assessment of the effectiveness of the company's internal control structure and procedures for financial reporting. The Act also required registered public accounting firms to attest to, and report on, that management assessment. Section 302 of the Act required the SEC to prescribe rules on CEO and CFO

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certification of various matters related to internal controls, and the SEC issued those final rules on August 29, 2002.

**What is the nature of the annual internal controls report that the SEC proposes?**

Under the proposed rule, each public company would be required to include in its Form 10-K an internal controls report of management that includes:

- A statement of management's responsibility to establish and maintain adequate "internal controls and procedures for financial reporting";
- Conclusions about the effectiveness of the company's internal controls and procedures for financial reporting based on management's evaluation of those controls and procedures, as of the end of the company's most recent fiscal year;
- A statement that the registered public accounting firm that prepared or issued the company's annual audit report has attested to, and reported on, management's evaluation of the company's internal controls and procedures for financial reporting; and
- An attestation report from the auditors of the company's financial statements, providing the opinion of the auditors as to whether the company's disclosure about the effectiveness of its internal controls and procedures for financial reporting purposes is fairly stated in all material respects.

**Is the SEC proposing other requirements regarding internal controls and procedures?**

In its August 29, 2002 final rules under Section 302 of the Sarbanes-Oxley Act, the SEC required disclosure in Forms 10-K and 10-Q, under a new Item 307 of Regulation S-K, about whether during the relevant period there were significant changes to the company's internal controls or in other factors that could significantly affect those controls subsequent to the evaluation of effectiveness of the company's disclosure controls and procedures. To provide a basis for this quarterly disclosure, and to create symmetry between the SEC's requirements for periodic evaluations of the company's disclosure controls and procedures and its internal controls and procedures for financial reporting, the SEC now proposes that the company's management also evaluate the effectiveness of the design and operation of the company's internal controls and procedures for financial reporting. This evaluation would be done at the end of each quarter, for disclosure in each annual or quarterly report.

**How is "internal controls and procedures for financial reporting" defined?**

This is a new term. It was devised by the SEC as a specific term to mean controls that pertain to the preparation of financial statements for external purposes that are fairly presented in conformity with GAAP, as addressed by the AICPA's Codification of Statements on Auditing Standards Section 319, or any superseding definition that is issued or adopted by the new Public Company Accounting Oversight Board.

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Specifically, "internal control" means a management process that is designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- reliability of financial reporting;
- effectiveness and efficiency of operations; and
- compliance with applicable laws and regulations.

**Don't public companies already review their internal controls as part of their annual audit?**

Yes, but the SEC believes that the proposed assessment, report and attestation would be more thorough and more detailed than reviews of internal controls have tended to be.

**How do "internal controls and procedures for financial reporting" relate to the Company's "disclosure controls and procedures"?**

"Disclosure controls and procedures" is another new term that the SEC coined as part of its August 2002 release on CEO and CFO certifications under Section 302 of the Sarbanes-Oxley Act. The SEC defined that term to mean a company's controls and other procedures that are designed to ensure that information required to be disclosed by the company in its Exchange Act reports is recorded, processed, summarized and reported in a timely fashion. Disclosure controls and procedures include measures designed to ensure that information that is required to be disclosed by a company in its Exchange Act reports is accumulated and communicated to management as appropriate to allow timely decisions regarding required disclosure.

In contrast, "internal controls and procedures for financial reporting" as proposed is more specifically focused on the fair presentation of financial information in accordance with GAAP.

**Is the SEC proposing to make changes to its requirements regarding "disclosure controls and procedures"?**

Yes. The SEC has proposed to make some refinements to the rules it issued on August 29, 2002 implementing Section 302 of the Act. These proposed refinements include a requirement that management's assessment of the effectiveness of the disclosure controls and procedures be made as of the end of the applicable quarterly or annual period, rather than within a 90-day period prior to the filing of the report that relates to that period.

**Won't it take time for public companies and the accounting profession to develop standards and processes to evaluate internal controls and procedures for financial reporting?**

Yes. As a result, the SEC has recommended that these rules, as well as the proposed changes to existing rules adopted in connection with Section 302 of the Act, only apply to companies whose fiscal years end on or after September 15, 2003.

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## **What if I have more questions?**

Should you have any questions about these new requirements, please feel free to contact any member of your Fenwick & West team. You may also contact Horace Nash ([hnash@fenwick.com](mailto:hnash@fenwick.com)), Laird Simons ([lsimons@fenwick.com](mailto:lsimons@fenwick.com)) and Eileen Duffy Robinett ([erobinett@fenwick.com](mailto:erobinett@fenwick.com)), each of whom contributed to the preparation of this update.