



**FENWICK & WEST LLP**

*CORPORATE & SECURITIES LAW UPDATE*

## **SEC Issues Final Rule Mandating Disclosure About Audit Committee Financial Experts**

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## SEC Issues Final Rule Mandating Disclosure About Audit Committee Financial Experts

On January 15, 2003, the SEC adopted a final rule to implement Section 407 of the Sarbanes-Oxley Act of 2002, requiring public companies to disclose whether their audit committees include at least one member who is a financial expert and defining the term “financial expert.” The complete text of the final rule can be found at [www.sec.gov/rules/final/33-8177.htm](http://www.sec.gov/rules/final/33-8177.htm).

### What does the new rule require?

The new rule effectively requires a public company’s board of directors to determine whether the company has an “audit committee financial expert” serving on its audit committee. The company must then disclose that its board of directors has determined that it either:

- has at least one audit committee financial expert serving on its audit committee; or
- does not have an audit committee financial expert serving on its audit committee.

If the former, the company must disclose the name of the audit committee financial expert and whether that person is “independent” of management (see below). If the latter, the company must explain why it does not have an audit committee financial expert. A company disclosing that it does not have an audit committee financial expert is permitted to explain the aspects of the definition that various board members satisfy.

A company cannot satisfy the new disclosure requirements by stating that it has decided not to make a determination, or simply by disclosing the qualifications of all its audit committee members.

### Where must a company make these required disclosures?

Public companies must provide the required information in their annual reports filed with the SEC. A domestic public company instead may disclose the information in its proxy statement and incorporate that information by reference into its annual report.

### When are the new rules effective?

Companies other than small business issuers must provide the required disclosures in their Forms 10-K (or other annual report) for fiscal years ending on or after July 15, 2003. Small business issuers must provide the required disclosures in their Forms 10-KSB for fiscal years ending on or after December 15, 2003.

### What is an “audit committee financial expert?”

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

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- an understanding of generally accepted accounting principles and financial statements;
  - the ability to assess the general application of these 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 company's financial statements, or experience actively supervising one or more persons engaged in these activities;
  - an understanding of internal controls and procedures for financial reporting; and
  - an understanding of audit committee functions.

To qualify as an audit committee financial expert, this person must have acquired these 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 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.

If a company relies on a person's "other relevant experience," it must include in its SEC disclosures a brief listing of that person's relevant experience. It can provide that listing by making reference to disclosures in that person's biography elsewhere in the same SEC filing.

**What is required for an audit committee financial expert to be "independent?"**

Independence is determined by reference to the stock exchange or self-regulatory organization listing standards relevant to the company. In the case of most Silicon Valley companies, this will be NASD Rule 4200(a)(14), as it may be modified or supplemented from time to time. This rule currently defines "independent director" to be a person other than:

- an officer or employee of the company or its subsidiaries, or

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- any other individual having a relationship that, in the opinion of the company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.

The current rule specifically precludes the following additional persons from being considered independent:

- a director employed by the company (or any of its affiliates) for the current year or any of the past three years;
- a director who accepted any compensation from the company (or any of its affiliates) in excess of \$60,000 during the previous fiscal year, other than compensation for board service, benefits under a tax-qualified retirement plan or nondiscretionary compensation;
- a director who is a member of the immediate family 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 for-profit business organization to which the company made, or from which the company received, payments that exceed 5% of the company's or business organization's revenues for that year, or \$200,000, whichever is more, in any of the past three years; and
- a director employed as an executive of another entity where any of the company's executives serve on that entity's compensation committee.

The NASD proposed revisions to this rule in October 2002, but no action has yet been taken on these revisions. The proposed revisions would change the term "any of its affiliates" to "parent or subsidiary of the company," thereby, for example, clarifying that directors who are principals in venture capital funds owning a significant percentage of the company are not disqualified automatically from being deemed independent. Otherwise, the proposed revisions tend to make the requirements for independence more demanding.

**How should a board of directors determine whether a candidate is a financial expert?**

A board of directors, in determining which of its audit committee members may be an audit committee financial expert, should consider all the available facts and circumstances, including, but certainly not limited to, qualitative factors such as the director's:

- level of education in finance or accounting;
- status as a CPA, and the amount of time spent actively practicing as a CPA;
- status as a certified accounting or financial expert, and for how long;

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- 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.

The SEC specifically noted that, in determining whether a person possesses an appropriate degree of knowledge and experience, a board of directors must ensure that it names an audit committee financial expert who embodies the highest standards of personal and professional integrity. In this regard, the board should consider any disciplinary actions to which a potential expert is, or has been, subject in determining whether that person would be a suitable audit committee financial expert.

**What if a company has more than one audit committee financial expert?**

The final rule permits a company to disclose that it has more than one audit committee financial expert serving on its audit committee. Therefore, once a company's board determines that a particular audit committee member qualifies as an audit committee financial expert, it may, but is not required to, determine whether additional audit committee members also qualify as experts. If the company elects to disclose that it has more than one audit committee financial expert serving on its audit committee, it must also name the additional persons and indicate whether they are independent.

**May a company with an audit committee financial expert indicate that it has no such expert?**

No. If the company's board determines that at least one audit committee member qualifies as an audit committee financial expert, the company must accurately disclose this fact. It is not appropriate to disclose that the company has no audit committee financial expert if its board has determined that such an expert serves on the audit committee.

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**Might professionals such as venture capitalists, investment bankers and financial analysts qualify as audit committee financial experts?**

Yes. The SEC's proposed rule would have required that a financial expert have experience "preparing or auditing" financial statements. The final rule and promulgating release make clear that experience performing in-depth "analysis and evaluation" of financial statements will suffice if an individual possesses all the other attributes required of an audit committee financial expert. The SEC explicitly made this change to broaden the group of persons eligible to be audit committee financial experts. The SEC recognized that many people actively engaged in industries such as investment banking and venture capital investment have significant direct and close exposure to, and experience with, the content of financial statements and the processes behind them. Similarly, they acknowledged that professional financial analysts closely scrutinize financial statements on a regular basis. In fact, the SEC noted with approval that individuals with these backgrounds often hold positions that require them to inspect financial statements with a healthy dose of skepticism. The SEC therefore viewed them as well prepared to question management and auditors diligently and zealously about the company's financial statements.

**Do chief executive officers or chief operating officers qualify as audit committee financial experts?**

They may. The SEC broadened its proposed definition to include individuals with experience "actively supervising" one or more persons engaged in preparing, auditing, analyzing or evaluating financial statements. However, they made clear their belief that "active supervision" means more than the mere existence of a traditional hierarchical reporting relationship between the supervisor and those being supervised. They stated that they intended to include only persons who participate in and contribute to, albeit at a supervisory level, the process of addressing the same general types of issues regarding preparation, auditing, analysis or evaluation of financial statements as those addressed by the person or persons being supervised. The SEC intends "actively supervised" to mean that the supervisor has experience that has contributed to the general expertise necessary to prepare, audit, analyze or evaluate financial statements that is at least comparable to the general expertise of those being supervised. A principal executive officer should not be presumed to qualify. For example, the SEC indicated that a principal executive officer with considerable operations involvement, but little financial or accounting involvement, likely would not be exercising the active supervision necessary to qualify as an audit committee financial expert.

**Must an audit committee financial expert have experience in the relevant industry?**

No. Familiarity with particular financial reporting or accounting issues, or any other narrow area of experience, is not required and should not be dispositive. The SEC also clarified that the phrase "experience with financial statements that present accounting issues that are 'generally comparable' to those raised by the company's financial statements" does not

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imply that a person must have previous experience in the same industry as the company that is evaluating the person as a potential audit committee financial expert. Rather, the appropriate focus is on the breadth and level of complexity of the accounting issues with which the person has had experience. The SEC leaves it up to the board of directors to make the necessary assessment based on the particular facts and circumstances, suggesting that, in making its assessment, the board should focus on a variety of factors, such as the size of the company with which the person has had experience, the scope of the company's operations and the complexity of its financial statements and accounting.

**Must an audit committee financial expert have experience in or with U.S. public companies?**

Not necessarily. The SEC noted that many private companies are contractually required to prepare audited financial statements that comply with generally accepted accounting principles. They also noted that a potential expert may have gained relevant experience at a foreign company that is publicly traded in its home market but that is not a U.S. public company registered under the Securities Exchange Act of 1934.

**Are there any categories of persons who would automatically qualify as audit committee financial experts?**

No. For example, the fact that a person previously has served on an audit committee does not by itself justify a board of directors in "grandfathering" that person as an audit committee financial expert. Similarly, the fact that a person has experience as a public accountant or auditor, or as a principal financial officer, controller or principal accounting officer, does not by itself justify the board of directors in deeming that person an audit committee financial expert. The board must assess whether that person possesses an appropriate degree of knowledge, experience and integrity.

**Does designation as an audit committee financial expert expose the director to additional duties or liability?**

The SEC found no support in the Sarbanes-Oxley Act or in related legislative history that Congress intended to change the duties, obligations or liability of any audit committee member, including the audit committee financial expert, by passage of Section 407 of the Act. Nevertheless, to alleviate concerns expressed in the comment process, the SEC adopted safe harbor and guidance provisions as follows:

- the designation or identification of a person as an audit committee financial expert does not impose on that person any duties, obligations or liability that are greater than those imposed on that person as a member of the audit committee and board of directors in the absence of that designation or identification;
- the designation or identification of a person as an audit committee financial expert

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does not affect the duties, obligations or liability of any other member of the audit committee or board of directors; and

- a person who is determined to be an audit committee financial expert will not be deemed to be an “expert” for any purpose, including for purposes of registration statement liability under Section 11 of the Securities Act of 1933, as a result of being designated or identified as an audit committee financial expert. This last point also means that an audit committee financial expert is not subject to a higher level of due diligence with respect to any portion of a registration statement as a result of his or her designation or identification as an audit committee financial expert.

**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 Laird Simons ([lsimons@fenwick.com](mailto:lsimons@fenwick.com)) or Horace Nash ([hnash@fenwick.com](mailto:hnash@fenwick.com)), who contributed to this update.