Audit Committee Financial Experts

On January 23, 2003, the Securities and Exchange Commission published final rules requiring each public company board of directors to make a determination as to whether the company has an “audit committee financial expert” serving on its audit committee. If the board determines that the company has such an audit committee financial expert, the company must disclose that determination, the name of the expert and whether the expert is independent of management. If the board determines that the company has no such audit committee financial expert, the company must disclose that determination and explain why it has no such expert.

The SEC initially proposed rules on this subject on October 22, 2002, prompting more than 200 comment letters. Many commenters voiced a concern about the proposal’s narrow definition of financial expert and the potential liabilities to which a financial expert could be exposed. In response to the comments, the final rules incorporate a substantially broader definition of financial expert. The final rules also incorporate a provision stating that the designation of a person as an audit committee financial expert does not impose upon him any increased duties, obligations or liability.

The disclosure called for by the new rules is generally required to be included in Form 10-Ks or similar annual reports filed for fiscal years ending on or after July 15, 2003. Small business issuers are required to make the disclosure in annual reports for fiscal years ending on or after December 15, 2003. The information may be incorporated by reference from the company’s definitive proxy or information statement that involves an election of directors, if the company files such statement with the Commission no later than 120 days after the end of the fiscal year.

Statutory Background

The Commission’s rulemaking was mandated by Section 407 of the Sarbanes-Oxley Act of 2002, which directed the Commission to adopt rules to require disclosure about the presence or absence (and reasons for absence) of a financial expert on the audit committee.

Section 407 left the definition of the term “financial expert” to Commission rulemaking, but specified that in defining the term “financial expert,” the Commission must “consider” whether a person:

has, through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of an

---

If you have questions or would like additional information on the material covered in this Bulletin, please contact the author:
Robert K. Morris
(Pittsburgh)
412.288.3126
rmorris@reedsmith.com
... or the Reed Smith attorney with whom you regularly work.

---

This bulletin is presented for informational purposes and is not intended to constitute legal advice.
© Reed Smith LLP 2003. All Rights Reserved.
"Reed Smith" refers to Reed Smith LLP, a limited liability partnership formed in the state of Delaware.
client bulletin 03-13

issuer, or from a position involving the performance of similar functions -

1) an understanding of generally accepted accounting principles and financial statements;

2) experience in—
   A) the preparation or auditing of financial statements of generally comparable issuers; and
   B) the application of such principles in connection with the accounting for estimates, accruals and reserves;

3) experience with internal accounting controls; and

4) an understanding of audit committee functions.

required disclosure

under the final rules, a company must disclose either that its board of directors has determined that the company has at least one audit committee financial expert serving on its audit committee, or that the board has determined that it does not have an audit committee financial expert serving on its audit committee.6

every company subject to the disclosure requirements must secure a board determination that it either has, or does not have, at least one audit committee financial expert. a disclosure that the board considered the question, but was unable to make a determination, would not satisfy the requirement, nor would disclosure that the board had not considered the issue. the board’s determination must be accurately disclosed. thus, if the board determines that it has an audit committee financial expert, the company may not (because of individual liability concerns or otherwise) omit disclosure of this determination.

the rule requires that the audit committee financial expert be named.7 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 and the company may, but is not required to, disclose their names.

the final rules require, as did the proposed rules, that a company must disclose whether its audit committee financial expert is independent of management.8 independence is defined by reference to item 7(d)(3)(iv) of schedule 14a, which incorporates the applicable independence standard of the new york stock exchange,9 amex10 or nasdaq,11 as the case may be.

if the board determines that the company has no audit committee financial expert serving on its audit committee, it must disclose that fact.12 and, it must explain why it does not have an audit committee financial expert.13 the nature of such an explanation would presumably vary with the circumstances of the particular company, but conceivably could include a description of the basis for the board’s determination that the existing audit committee did not include an audit committee financial expert, together with a description of the qualifications which the audit committee members do possess and, perhaps, a description of the company’s efforts to locate and recruit for audit committee service a person having the requisite qualifications to serve as an audit committee financial expert, against the backdrop of other qualifications the company seeks from all board members.

definition of audit committee financial expert

the final rules define an audit committee financial expert as a person who has five specified attributes, acquired through one or more of four types of experience. the provisions relating to both the attributes and the experience were significantly expanded from the rules as initially proposed.

the first required attribute is an “understanding of generally accepted accounting principles and financial statements.” this attribute, which is also contained in the sarbanes-oxley act, was carried forward unchanged
Consistent with the statutory purpose and the other features of the final rules, the word “understanding” here should not be interpreted as requiring a detailed knowledge of the myriad specialized rules which make up the body of generally accepted accounting principles. The adopting release stressed the Commission’s view that the definition of audit committee financial expert should not focus so strictly upon highly specialized technical knowledge as to result in a very limited pool of candidates. Instead, what is necessary is the ability to understand the general application of accepted accounting principles to the company’s financial statements. This direction is clarified in the second attribute.

The second required attribute is the ability to assess the general application of generally accepted accounting principles in connection with the accounting for estimates, accruals and reserves. The rules as originally proposed would have required such experience with specific reference to estimates, accruals and reserves “generally comparable” to those confronted by the company. Many commenters argued that this comparability requirement would require particular experience with the same specialized issues faced by the company and could substantially narrow the pool of candidates, especially if a company wished to exclude persons having connections with competitors. As a result, the comparability requirement was deleted, and the words “general application” of accounting principles were used to describe the necessary ability. Consequently, companies will have the flexibility to choose persons having general, not industry-specific or issue-specific, expertise.

The third required attribute is experience in 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 such activities. This attribute in the final rules represents an expansion from the initial proposal in three ways.

First, the attribute may be satisfied by experience in analyzing or evaluating financial statements; under the proposed rule only experience in preparing and auditing financial statements would suffice. In this way the Commission sought to broaden the pool of candidates beyond persons who are simply accounting experts. The Commission recognized that persons engaged in financial statement analysis and evaluation, such as in investment banking and venture capital investment, could well possess the necessary expertise and skeptical mindset to diligently and zealously discharge their audit committee responsibilities.

Second, the attribute may be satisfied by experience with financial statements presenting issues of comparable “breadth and complexity”; the proposed rule would have required experience with financial statements presenting issues “generally comparable” to those faced by the company. This drafting change was intended to negate the implication that the audit committee financial expert must have prior familiarity with the particular issues which the company is facing.

Third, the attribute may be satisfied by the experience of actively supervising a person who prepares, audits, analyzes or evaluates financial statements; the proposed rule contained no active supervision concept. Active supervision here means more than the existence of a structural reporting relationship between the supervisor and the person being supervised. The supervisor here must have participated in and contributed to the process of addressing issues presented in the preparation, auditing, analysis or evaluation of financial statements. The adopting release states that a principle executive officer “should not be presumed to qualify.” However, a principal executive officer with active financial and accounting involvement would qualify.

The fourth required attribute is an “understanding of internal controls and procedures for financial reporting.” The proposed rule required experience with internal controls and procedures; the final rule focuses on the requirement that the audit committee financial expert understand why internal controls and procedures exist, how they were developed, and how they operate, without requiring specific experience.

The fifth required attribute, unchanged from the proposed rule, is an “understanding of audit committee functions.”
Under the final rule, the audit committee financial expert must have acquired the five required attributes through one of four specified ways:

- 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; or
- Experience actively supervising one of such persons; or
- 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. \(^{20}\)

These provisions broaden the proposed rule in a number of respects. First, the proposed rule specified that the financial expert must have obtained his experience with a public reporting company. This requirement was deleted. Second, the final rule adds a provision that experience overseeing or assessing the performance of companies or public accountants can meet the requirement. The adopting release notes that, for example, certain individuals serving in governmental, self-regulatory and private sector oversight bodies may qualify. Third, the proposed rule, in the final catch-all category, had required experience in a position resulting, in the judgment of the board, in the person’s having expertise and experience similar to a principal financial officer, principal accounting officer, controller, public accountant or auditor. The final rule changes this to require simply “other relevant experience.” No disclosure is required, contrary to the proposed rule, of the basis for the board’s determination that the person has “similar expertise and experience” to the enumerated positions; instead, disclosure is simply required of the nature of the person’s experience. \(^{21}\)

The expansion of the definition of audit committee financial expert effected by the final rules will afford companies a more realistic opportunity to obtain a person meeting the requirements for service on the audit committee. A board will wish to document the basis for its decision that a particular individual qualifies. This documentation should focus on the basis for a determination that each of the required attributes has been met, and that such attributes have been acquired in one or more of the required ways. The documentation could take the form of a director questionnaire, or a memorandum of an interview with the director, but should in any event evidence direct inquiry of the director on the relevant criteria. A board may also find it helpful to secure an opinion of counsel as to whether the designated individual meets the Regulation S-K, Item 401 requirements to qualify as an audit committee financial expert.

Liability Safe Harbor

In response to commenter concerns, the Commission included in the final rules a codification of the Commission’s position that it would be adverse to the interests of investors and to the operation of markets if the designation and identification of an audit committee financial expert affected such person’s, or any other director’s, duties, obligations or liability exposure. As a result, the rules provide that such designation will not have such effect. \(^{22}\) The rules make such provision under federal law, by stating that an audit committee financial expert will not be deemed an “expert” for any purpose, including without limitation for purposes of Section 11 of the Securities Act, by virtue of such designation. The rules also make such provision more generally, without specific limitation to federal law, by simply stating that such designation does not affect such person’s or any director’s duties, obligations or liability. However, to the extent such matters are governed by state law, a question may be raised as to the Commission’s power to alter otherwise applicable legal standards.

Substantive Membership Requirements

As noted, the Commission’s rulemaking does not mandate membership of an audit committee financial expert on a public corporation’s audit committee—it simply provides for disclosure.
Substantive requirements for audit committee membership are currently set forth in exchange listing standards. The New York Stock Exchange provides that at least one member of a listed company audit committee must have “accounting or related financial management expertise, as the Board of Directors interprets such qualification in its business judgment.” NASDAQ and the AMEX require each listed company to certify that it has at least one member of the audit committee that has former employment experience in finance or accounting, a professional certification in accounting, or comparable experience or background that demonstrates the individual’s financial sophistication. These rules provide, for example, that a chief executive officer, chief financial officer or other senior corporate officer with financial oversight responsibilities would satisfy the requirement. Currently, these rules permit significantly more leeway in determining whether an individual has the requisite expertise than the Commission rules.

However, the self-regulatory organizations are considering new substantive requirements relating to the makeup of audit committees. On August 16, 2002, the NYSE filed with the Commission proposed rule changes including proposals relating to audit committee composition. With regard to a requirement of financial expertise for at least one audit committee member, the NYSE filing indicated that the NYSE has determined to await the Commission’s interpretation of “financial expert” before making a recommendation on this point. No recommendation has yet been forthcoming.

On October 9, 2002, NASDAQ filed with the Commission proposed rule changes including a proposal relating to audit committee composition. The proposal included the following:

[E]ach issuer must certify that it has, and will continue to have, at least one member of the audit committee who is a financial expert. In determining whether an audit committee member is a financial expert, the board must consider whether a person has, through education and experience as a public accountant or auditor or principal financial officer, comptroller or principal accounting officer of an issuer or from a position involving the performance of similar functions, sufficient financial expertise in the accounting and auditing areas, as specified in Section 407(b) of the Sarbanes-Oxley Act, and as may be established by the SEC in rulemaking under the Sarbanes-Oxley Act.

The AMEX Board of Governors approved proposed changes to the AMEX audit committee membership requirements on November 25, 2002. The text of these changes is not yet available; however, the description of the changes on the AMEX website indicates that audit committee requirements will be conformed to the requirements of the Sarbanes-Oxley Act.

The Commission has indicated that it will continue to work with the self-regulatory organizations “to reconcile to the extent possible the various definitions of expert.” The situation is currently very much in flux. The Commission has not yet published a formal notice of filing of the proposed audit committee rule changes by any of the self-regulatory organizations, which will trigger a comment period on the proposals. At a recent webcast conducted by the NYSE, an Exchange official speculated that any new substantive rules will not become effective before the second quarter of 2003.

* * * * * * *

Reed Smith, a leading global law firm with nearly 1,000 lawyers located in 16 U.S. and two U.K. cities, represents Fortune 100 as well as mid-market and emerging companies. Clients include technology companies and entrepreneurs, financial services firms, health care providers and insurers, communications companies, manufacturers, universities, non-profit organizations, real estate developers, and municipalities throughout the United States and in 40 countries. For more information, please visit reedsmith.com.
The final rules use the term “audit committee financial expert” in place of the term “financial expert.” The release states that this term suggests more pointedly that the designated person has characteristics that are particularly relevant to the functions of the audit committee.

Forms 10-KSB; 20-F and 40-F.


Sections 303.01(B)(2)(a) and (3) of the NYSE’s listing standards.

Section 121(A) of the AMEX’s listing standards.

Rule 4200(a)(15) of NASDAQ’s listing standards.

The final rules include an instruction that for foreign private issuers, the term “generally accepted accounting principles” means the body of such principles used by the issuer in its primary financial statements.

In this sense, this attribute may be considered as roughly comparable to the current NYSE requirement that one member of the audit committee have accounting or related financial management expertise. NYSE Rule 303.01(B)(2)(c). See also AMEX Rule 121(B)(b)(i); NASDAQ Rule 4350(d)(2)(A).