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HRO Alert

The Sarbanes-Oxley Act of 2002

Final Rules: **AUDIT COMMITTEE FINANCIAL EXPERT**

On January 23, 2003, the SEC released final rules relating to disclosure regarding "audit committee financial experts." These rules, issued under the Sarbanes-Oxley Act of 2002 (the "SO Act"), finalize and, in some cases, revise the SEC's proposed rules relating to audit committee financial experts, which were released on October 22, 2002.

This HRO Alert summarizes the main provisions of the final rules. Public companies (other than small business issuers) must provide the required disclosures in their annual reports for fiscal years ending on or after July 15, 2003. Small business issuers must include the disclosures in their annual reports for fiscal years ending on or after December 15, 2003. Thus, companies that have a December 31 fiscal year must first disclose their audit committee financial expert(s) in their annual report filed during the first quarter of 2004.

The final rules adopt new Item 401(h) of Regulation S-K. Under the final rules, each public company must disclose in its annual report the determination by its board of directors that the company either has or does not have at least one audit committee financial expert serving on the audit committee. The disclosure also may be included in the company's proxy statement and incorporated by reference into its annual report. If the company does have at least one audit committee financial expert, it must name that individual. The company is permitted, but not required, to disclose that it has more than one audit committee financial expert. If the company does not have any audit committee financial experts on its audit committee, it must disclose that fact and explain why. The company (other than a foreign private issuer) also must disclose whether each person identified as an audit committee financial expert is an "independent" director. The SEC indicated that once its independence rules under Section 301 of the SO Act are finalized, these rules will be revised to incorporate the new standard.

Under the final rules, an audit committee financial expert is defined as someone who has the following attributes:

- An understanding of generally accepted accounting principles and financial statements (with respect to a foreign private issuer, this means that company's home GAAP);
- The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;
- Experience in preparing, auditing, analyzing or evaluating financial statements that present a 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;
- An understanding of internal controls and procedures for financial reporting; and
- An understanding of audit committee functions.

Under the final rules, a person must have acquired such attributes through any 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 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.

In response to commenters' concerns that the definition of audit committee financial expert was too restrictive, the SEC eliminated aspects of the proposed definition that would have required experience with comparable financial statements or a comparable company. The SEC also eliminated proposed requirements of direct experience preparing or auditing financial statements and experience with a public company required to file periodic reports. Finally, the final rules eliminated a proposed instruction listing factors that a company's board could consider in evaluating a candidate for audit committee financial expert.

The board must make the determination of audit committee financial expert based on all relevant factors. With the "other relevant experience" element, the SEC recognized that the necessary qualifications may be obtained in many ways. However, the SEC emphasized the importance of actual experience, rather than simply education. If the "other relevant experience" alternative is relied upon, the company must briefly describe that experience.

Several stock exchanges and Nasdaq currently have rules requiring audit committees to have one member that is financially sophisticated or possesses accounting or related financial management expertise. An individual who meets these requirements may or may not qualify as an audit committee financial expert under the SEC's definition. The New York Stock Exchange and Nasdaq have proposed amending their audit committee requirements to require an audit committee financial expert in accordance with the requirements of the SO Act and these final rules.

The proposed rules provided that designation of an individual as an audit committee financial expert would not make that individual an expert for purposes of liability under Section 11 of the Securities Act of 1933. In response to concerns about heightened liability for audit committee financial experts, the final rules also include a safe harbor clarifying that designation as an audit committee financial expert does not impose any greater duties, obligations or liability than that imposed on other members of the audit committee or the board of directors, or reduce the duties, obligations or liability of any other member of the audit committee or board of directors.

HOW HRO CAN HELP

These final rules will affect your company's disclosure in its annual reports and may affect the composition of your company's audit committee. If you would like to discuss these rules and how they may affect your company, we encourage you to contact any of the persons listed in the margin of the first page of this HRO Alert.

This HRO Alert is a periodic publication of Holme Roberts & Owen LLP and should not be construed as legal advice or legal opinion on any specific facts or circumstances. Nor is it intended to address specific disclosure or compliance issues that may arise in particular circumstances or all of the provisions included in the newly adopted rules. The contents are intended for general informational purposes only, and you are urged to consult counsel concerning your own situation and any specific legal questions you may have. For further information regarding the rules described herein, please contact any of the persons listed in the margin of the first page of this HRO Alert.

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