



TROUTMAN SANDERS LLP

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SEC ISSUES FINAL RULES REGARDING AUDIT COMMITTEE FINANCIAL EXPERTS

On January 24, 2003, the Securities and Exchange Commission released its final rules implementing Section 407 of the Sarbanes-Oxley Act of 2002. Under the new rules, a public company will now be required to disclose on an annual basis whether it has a financial expert serving on the audit committee of its board of directors.

Where and When to Disclose Financial Expert Information

Item 401 of Regulations S-K and S-B will now require a company subject to the reporting requirements of the Securities Exchange Act of 1934 to include a new type of disclosure in its Exchange Act filings. The company will be required to annually disclose whether it has a financial expert serving on its audit committee.

- If the company does have a financial expert serving on its audit committee, it must disclose the name of the audit committee financial expert and whether the expert is independent of management. If an audit committee has more than one financial expert, the company may disclose this fact, but it is not required to do so.
- If the company does not have such a financial expert, it must explain why it does not.

A company must include this information in its Annual Reports on Forms 10-K and 10-KSB for United States companies, Form 20-F for foreign issuers and Form 40-F for Canadian issuers. A domestic company also may incorporate this information by reference to a definitive proxy or information statement that involves the election of directors if the company voluntarily chooses to include this information in its proxy or information statement and then files that statement with the SEC not later than 120 days after the end of the fiscal year covered by the applicable Form 10-K. A company, other than a small business issuer, must comply with this new disclosure requirement in its Annual Report for fiscal years ending on or after July 15, 2003. A small business issuer must comply in its Annual Report for fiscal years ending on or after December 15, 2003.

Who is a Financial Expert

This is the most complicated and controversial aspect of the new rules relating to audit committee financial experts. While the Sarbanes-Oxley Act does not explicitly state who at the company should make this determination, the SEC has indicated that the board of directors, as the most broad-based body within the company, is best-equipped to determine which members of the audit committee qualify as audit committee financial experts.

To qualify as an audit committee financial expert under the new rules, a board member must possess all of the following five attributes:

- An understanding of generally accepted accounting principles and financial statements;
- The ability to assess the general application of such 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 registrant'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.

The new rules provide that the audit committee financial expert may have acquired such attributes through any one or more of the following means:

- 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 comments to its initial rule proposal, the SEC expanded the definition of an audit committee financial expert in two significant ways. First, because of concerns that the proposed definition would require an audit committee financial expert to have direct previous experience in a company's particular industry, the SEC eliminated a phrase requiring that a director possess experience accounting for estimates, accruals and reserves "that are generally comparable to the estimates, accruals and reserves, if any, used in the registrant's financial statement." Second, due to concerns that requiring an expert to have direct experience preparing or auditing financial statements would impose an undue burden on some companies, the proposed definition was significantly expanded to include a director who has actively supervised these activities.

Safe Harbor for Financial Experts

The new SEC rules provide specific safe harbor protections for audit committee financial experts designed to make clear that:

- An audit committee financial expert will not be deemed an "expert" for any purpose, including for purposes of Section 11 of the Securities Act of 1933;
- Designation as the audit committee financial expert does not (at least in the SEC's view) impose a higher degree of individual responsibility or any additional duties or obligations on the designee; and
- Designation does not decrease the duties and obligations of the other audit committee and board members.

Practical Impact of the Rule

It is important to keep in mind that these new SEC rules do not require a company to have an audit committee financial expert serving on its board of directors. They simply impose a new disclosure requirement relating to audit committee financial experts.

For a company that currently has an audit committee financial expert serving on its audit committee, the new rules should not present much of an issue. Under the new rules, the company will simply be required to disclose annually the name of its audit committee financial expert and whether the expert is independent of management.

On the other hand, a company that does not currently have an audit committee financial expert serving on its board of directors is faced with a tough choice under the new SEC rules. Prior to the time the first disclosure is due under the new rules, the company must either identify, recruit and add to its audit committee a new board member meeting the SEC's strict definition for an audit committee financial expert or be prepared to disclose publicly that its audit committee does not include a "financial expert" and to explain why that is the case. We expect that many, if not most, smaller public companies will take this latter path.

Contact Us

If you have any questions or comments, please let any member of our Corporate and Securities Group know, or you can contact the individuals listed below:

Atlanta

Jim Smith	james.smith@troutmansanders.com	(404) 885-3111
Brink Dickerson	brink.dickerson@troutmansanders.com	(404) 885-3822
Claire Barnett	claire.barnett@troutmansanders.com	(404) 885-3056

Northern Virginia/Virginia Beach

Jim Wheaton	jim.wheaton@troutmansanders.com	(757) 687-7719
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Richmond

Jay Johnston	jay.johnston@troutmansanders.com	(804) 697-1214
Jeff Gill	jeff.gill@troutmansanders.com	(804) 697-1332
Susan Ancarrow	susan.ancarrow@troutmanders.com	(804) 697-1861

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