

October 29, 2002

Audit Committee/Financial Expert

A provision of the Sarbanes-Oxley Act requires at least one *financial expert* on the audit committee of a public company or, alternatively, an explanation in the Form 10-K as to why the company's audit committee does not include a *financial expert*. Last week the SEC proposed a rule defining *financial expert* as that term is used in the Act. Unfortunately, the SEC rule adheres too closely to the specific guidance of the Act and requires that a *financial expert* have, through experience as a public accountant or auditor or a principal financial officer, controller or principal accounting officer of a public company or "performance" of similar functions, experience with internal controls and in preparing or auditing comparable financial statements. The proposed SEC rule delegates to the company's board of directors the determination of whether a person meets the definition, but, unless changed by the SEC, leaves little room for the board to determine that a person who was not a public accountant or a CFO or a senior accounting officer of a public company qualifies as a *financial expert*.

The SEC has indicated some receptivity for change by asking for comments on the following:

- Should we require a *financial expert* to have direct experience preparing or auditing financial statements of reporting companies? Should experience reviewing or analyzing such financial statements suffice? If so, why?

As an alternative to recognizing "reviewing or analyzing" as sufficient to justify a person being deemed a *financial expert*, the SEC could recognize in its final rule that "performance" is subsumed in "supervision" of people who performed the enumerated functions. Either approach would qualify CEOs and COOs, who have not themselves actually performed the functions, as *financial experts*. Such recognition would not do violence to the intent of the Act in that members of audit committees should not function as auditors or accounting experts; rather they should have the background and the experience necessary to properly monitor the performance of the independent auditors and the internal accountants. The SEC did recognize in the proposed rule that a key qualification is the ability to perform this monitoring function by

*If your address changes or if you do not wish to continue receiving these memos,  
please send an e-mail to [rt@wlrk.com](mailto:rt@wlrk.com) or call 212-403-1788.*

including the following factor in the list of qualifications the board should consider in determining whether a director is a *financial expert*:

- Whether the person has any other relevant qualifications or experience that would assist him or her in understanding and evaluating the registrant's financial statements and other financial information and to make knowledgeable and thorough inquiries whether:
  - The financial statements fairly present the financial condition, results of operations and cash flows of the company in accordance with generally accepted accounting principles; and
  - The financial statements and other financial information, taken together, fairly present the financial condition, results of operations and cash flows of the company.

If the SEC does not accept "reviewing or analyzing" as sufficient or does not recognize that "performance" is subsumed in supervision of people who performed the enumerated functions or does not otherwise broaden its rule proposal, a large number of companies will not have a *financial expert*. This would leave companies with two choices:

1. 1. The company is successful in recruiting a director who satisfies the attributes prescribed in the proposed rule and the board determines that this person is a *financial expert*.

2. 2. The company does not find a person who both meets the company's criteria for board membership and also qualifies as a *financial expert* and therefore makes the Form 10-K disclosure that it does not have a *financial expert* and the reason why. Such disclosure could, for example, read as follows:

At the present time no member of our Board of Directors serving on the Audit Committee meets the SEC definition of *financial expert*, which basically is limited to those who have prepared or audited comparable public company financial statements. While it might be possible to recruit a person who qualifies, the Board has determined that in order to fulfill all the functions of our Board and our Audit Committee, each member of our Board and our Audit Committee should meet all the criteria that have been established by our Board and our Nominating and Governance Committee for board membership, and it is not in the best interests of our Company to nominate as a director someone who does not have all the experience, attributes and qualifications we seek. Our Audit

Committee consists of [three] independent directors, each of whom has been selected for the Audit Committee by the Board based on the Board's determination that they are fully qualified to monitor the performance of management and our internal accounting operations and the independent auditors and are fully qualified to monitor the disclosures of the Company to the end that they fairly present the Company's financial condition and results of operations. In addition, the Audit Committee has the ability on its own to retain independent accountants or other consultants whenever it deems appropriate. Our Board believes that this is fully equivalent to having a *financial expert* on the Audit Committee.

This choice will undoubtedly result in some criticism from activist investors, but is not likely to be a significant problem for successful companies.

M. Lipton