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Securities Law Developments

CORPORATE FINANCE DEVELOPMENTS

Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees

On February 8, 1999, the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees issued its report and recommendations aimed at increasing the quality of corporate financial reporting. The eleven-member panel, consisting of stock-market regulators, accounting officials, and corporate executives, was sponsored by the New York Stock Exchange and the National Association of Securities Dealers. The Committee was formed in September 1998 in response to SEC Chairman Arthur Levitt's concerns about the adequacy of oversight of financial management and reporting. He pointed to a “gray area between legitimacy and outright fraud, ... where the accounting is perverted; where managers are cutting corners; and, where earnings reports reflect the desires of management rather than the underlying financial performance of the company.”[1/]

Chairman Levitt believes these problems can be addressed by strengthening the role of audit committees, and has expressed the view that “qualified, committed, independent and tough-minded audit committees represent the most reliable guardians of the public interest.”[2/] His stated goal is for “almost every company in America [to have] an audit committee made up of the right people, doing the right things and asking the right, tough questions.”[3/] In support of this vision, the Blue Ribbon Committee's Report appears to represent the beginning of bold and sweeping changes in listing requirements and corporate disclosure rules designed to enable audit committees to be a responsive link between management, auditors, the full board, and shareholders. The Committee uses the phrase “first among equals” to describe the role it envisions for audit committees.

1/ Arthur Levitt, *The Numbers Game* (Sept. 28, 1998) < http://www.sec.gov/news/speeches/ spch220.txt>.

2/ *Id.*

3/ Arthur Levitt, *A Partnership for the Public Trust* (Dec. 8, 1998) <http://www.sec.gov/news/speeches/ spch230.txt>.

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The Committee makes ten recommendations aimed at improving an audit committee's ability to evaluate and monitor the subjective and discretionary judgments often made by a company's financial management team. The changes fall into three primary categories: the independence of the audit committee members, the effectiveness of the audit committee's performance, and the audit committee's accountability for its oversight of management and auditors.

The recommendations, which we summarize below, call for new rules from the Commission, new requirements by the NYSE and the NASD for listed companies, and modifications to Generally Accepted Auditing Standards ("GAAS"). Some of the recommendations regarding NYSE and NASD requirements are only intended to apply to companies with a market capitalization above $200 million, recognizing that smaller companies will probably have a difficult time meeting some of the new requirements. The Committee uses $200 million market capitalization as the threshold, but suggests that the NYSE and the NASD adopt a more appropriate measure of size if warranted. The Report encourages adoption of the recommendations by the NYSE and the NASD in their entirety as a comprehensive effort to improve audit committees.

Independence

The Report's first two recommendations are directed at the degree of independence of audit committee members and reflect the Committee's view that such independence correlates to both a higher degree of active oversight and a lower incidence of financial statement fraud. These independence recommendations are intended to be applied by the NYSE and the NASD only to listed companies with a market capitalization above $200 million.

Recommendation 1

The Committee recommends the following definition of independence:

Audit committee members are to be considered independent if they have no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation.

Examples of relationships that would create a lack of independence include the following:

- a director being employed by the corporation or any of its affiliates for the current year or any of the past five years;
- a director accepting any compensation from the corporation or any of its affiliates other than compensation for board service or benefits under a tax-qualified retirement plan;

- a director being a member of the immediate family of an individual who is, or has been in any of the past five years, employed by the corporation or any of its affiliates as an executive officer;

- a director being a partner in, or a controlling shareholder or an executive officer of, any for-profit business organization to which the corporation made, or from which the corporation received, payments that are or have been significant to the corporation or business organization in any of the past five years;

- a director being employed as an executive of another company where any of the corporation's executives serve on that company's compensation committee.

A director who has one or more of these relationships may be appointed to the audit committee if the board, under exceptional and limited circumstances, determines that membership on the committee by the individual is in the best interests of the corporation and its shareholders, and the board discloses in the next annual proxy statement subsequent to such determination the nature of the relationship and the reasons for that determination.

The new independence standard reflects the Committee's concern that the current NYSE and NASD independence standards for audit committee members allow for too much discretion. Thus, the new standard is more explicit than the current NYSE and NASD standards. For example, although current NYSE rules require a listed company to have an audit committee consisting solely of independent directors, the NYSE defines independent directors as those who are "free from any relationship that, in the opinion of the Board of Directors, would interfere with the exercise of independent judgment of a committee member."[4/] Although affiliates, officers, and employees of the company are not considered independent, former officers may be considered independent if the board of directors determines that "such person will exercise independent judgment and will materially assist the function of the [audit] committee."[5/] And whereas former officers may not compose more than half of the audit committee under the current NYSE guideline,[6/] the new recommendation would require former officers to wait five years after their employment to serve on the audit committee.

As further example, under NYSE rules a director who provides additional services directly to the board of directors and is separately compensated for those services in addition to his customary role as director would still qualify for audit committee membership.[7/] This would not be possible under the new recommendation. A director would not be viewed as independent if he or she accepted any compensation from the board other than compensation for board service or benefits

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4/ NYSE Listed Company Manual § 303.00.

5/ *Id.*

6/ *Id.*

7/ *Id.*

under a tax-qualified retirement plan. The Committee does not address the issue of what forms director compensation may take.

Finally, under current NASD rules, a listed company must have an audit committee in which a majority of its members are independent directors. The NASD defines as independent anyone other than an officer or employee of the company or its subsidiaries or any other individual having a relationship that, in the opinion of the board of directors, would interfere with the exercise of independent judgment.[8] Again, a more stringent standard would apply under the new recommendation.

Recommendation 2

The Committee recommends that audit committees consist solely of independent directors, which could have a significant impact on publicly-held companies. The Wall Street Journal reports that about 125 of 860 such companies have current or former insiders on their audit committees.[9] As mentioned above, although the NYSE already requires all audit committee members to be independent directors, the NASD requires only a majority.[10]

Effectiveness

The Committee intends the second set of recommendations to improve the effectiveness of the audit committee in their oversight of the financial reporting process. According to the Report, one avenue of effectiveness is to require that audit committee members have an array of talent, experience, and expertise relevant to the many different aspects of the company's activities. The Committee also believes that audit committees will be more effective if they are diligent in defining their role, responsibilities, structure, and processes and memorialize those determinations in a charter.

Recommendation 3

Recommendation 3 would direct the NYSE and the NASD to require listed companies with a market capitalization above $200 million to have audit committees composed of the following:

- A minimum of three directors, each of whom is “financially literate.”
- At least one member of the audit committee with accounting or related “financial

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[8] NASD Manual, Rule 4460.

[9] Joann S. Lublin and Elizabeth MacDonald, *Panel to Propose Boosting Independence and Power of Board Audit Committees,* Wall St. J., Feb. 8, 1999, *available in* 1999 WL-WSJ 5439861.

[10] NYSE Listed Company Manual § 303.00; NASD Manual, Rule 4200(a)(13).

management expertise."

"Financial literacy" is the ability to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement. The recommendation allows for directors lacking in financial literacy to acquire it within a reasonable period of time after audit committee appointment.

"Financial management expertise" is past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background that results in the individual's financial sophistication, including current or former service as a CEO or other senior officer with financial oversight responsibilities.

Recommendation 4

The Committee recommends that the NYSE and the NASD require each listed company to adopt a formal written charter that specifies the scope of the audit committee's responsibilities and how the audit committee carries out those responsibilities. Companies would also be required to review and reassess the adequacy of the audit committee charter on an annual basis.

The Committee sets forth five principles to guide the development of a company-specific audit committee charter:

1) The audit committee should play a key role in monitoring the components of the audit process. This will require familiarity with the roles and responsibilities of each participant in the audit process and affirmation of a common understanding of the various roles by all involved.

2) Independent communication and a flow of information between the audit committee and the internal auditor are necessary. Meetings between the audit committee and the internal auditor should be regularized to remove whatever "taboo nature" or implication of "treason against management" such dialogues might carry in some current corporate environments.

3) Similarly, independent communication and information flow between the audit committee and outside auditors is necessary. Regularly scheduled meetings or reports could help facilitate frank, open dialogue. The audit committee will also want to ensure that information required by GAAS has been communicated to them by the outside auditor.

4) Candid discussions with management, the internal auditor, and outside auditors should be encouraged regarding issues that involve the exercise of judgment and its impact on the quality of the company's financial reporting. Management particularly should provide reports or review of the following information:

- financial statements and disclosure documents filed with the Commission;
- changes in accounting principles or financial policies;
- accounting treatment of significant transactions;
- significant variations between budgeted and actual numbers;
- second opinions sought from outside auditors regarding particular transactions; and
- management's response to internal or outside auditor assessments.

The audit committee should then discuss the above information provided by management with the internal auditor and outside auditors. The goal should be to verify management's compliance and to seek additional input regarding judgments made.

5) Audit committees should have diligent and knowledgeable members. In addition to Recommendations 2 and 3, audit committees should consider further qualifications for committee members. This may include training or education programs.

Recommendation 5

In an effort to keep audit committees from being merely nominal in nature, the Committee recommends that the Commission promulgate rules requiring audit committees to disclose in proxy statements whether a formal written charter has been adopted. If a charter is in place, the audit committee would be required to disclose whether the audit committee satisfied its responsibilities in compliance with the charter. The audit committee would also be required to disclose any significant modifications to the charter in the proxy statement, with a requirement that the charter be disclosed at least triennially if no changes are made. Although the Committee does not provide additional details, the recommendation appears to intend that there be an "audit committee report" similar to the "compensation committee report" presently required.

The Committee notes that it does not intend for such requirements to impose greater liability on the audit committee or the full board. The current standards for liability under the business judgment rule should continue. The disclosure should also be protected by an appropriate "safe harbor" provision. The Committee suggests that the "safe harbor" emulate the provision now applicable to an executive compensation committee's proxy statement report.

Accountability

The last five recommendations of the Report are directed at accountability among the audit

committee, the outside auditors, and management. The recommendations are directed at creating a flow of information and free communication among the three parties, with the goal of putting the audit committee in a better position to monitor what the others are doing and keeping management and outside auditors aware of their responsibilities. As the delegate of the full board, the audit committee is to be “responsible for overseeing the entire process.”

Recommendation 6

The Committee recommends that the NYSE and the NASD require audit committee charters to specify that outside auditors are ultimately accountable to the board of directors and the audit committee. The board of directors and the audit committee are to have the ultimate responsibility for selecting, evaluating, and, when appropriate, replacing outside auditors.

The Committee noted that auditors and management often develop close relations given the nature of the outside auditors' work in reviewing the many decisions and practices of management and managers' responsibilities for day-to-day operations. Thus, the recommendation is an effort to ensure that the audit committee regularly reviews the relationship between management and auditors. In this way, the audit committee can also serve as the primary link between the auditors and the full board.

Recommendation 7

The Committee recommends that the NYSE and the NASD require audit committee charters to specify that the audit committee has responsibilities regarding the independence of outside auditors. The audit committee is to ensure receipt of a formal written statement delineating all relationships between the auditor and the company. The audit committee is also actively to engage the auditor in a dialogue with respect to any disclosed relationships or services that might affect independence. Appropriate action should be taken by the audit committee or recommended to the board of directors when needed to ensure independence of outside auditors.

This recommendation is a counterpart to a new mandate imposed on outside auditors by the Independence Standards Board (“ISB”). The ISB recently adopted a new standard requiring that outside auditors

1) disclose in writing to the company's audit committee all relationships with the company that could affect the auditor's independence;

2) confirm its view that it is independent; and

3) discuss such matters with the audit committee.[11/]

[11/] AICPA Independence Standards Board, Standard No. 1, *Independence Discussions with Audit Committees* (Jan. 1999) <http://www.cpaindependence.org/pubs/isb1fina.htm>.

The Committee's recommendation is designed to ensure that the audit committee will be an active participant in the process mandated by the ISB.

Recommendation 8

As part of the effort to enable a closer relationship between auditors and the audit committee, and in recognition that the audit committee is dependent on management and outside auditors for much of its information, the Committee recommends modifying GAAS to require outside auditors to discuss with the audit committee the auditor's judgments regarding the quality of the company's financial accounting and reporting. Issues that should be addressed include the clarity of financial disclosures, the degree of aggressiveness or conservatism in the accounting principles used to make estimates, and other significant decisions.

Current auditing standards already require the auditor to report to the audit committee information regarding disagreements with management, consultations with other accountants, difficulties or delays caused by management, and "reportable conditions" that could adversely affect the company's ability to produce reliable financial statements.[12/] This information is often relayed to the audit committee in standardized letters. The Committee believes that a meaningful discussion between the audit committee and outside auditors will provide more complete information for the committee to make its evaluations.

Recommendation 9

Recommendation 9 suggests that the Commission require audit committees to include, as part of a company's Form 10-K Annual Report, a letter disclosing whether a discussion about the quality of the company's accounting principles and management's significant judgments affecting the company's financial statements occurred:

- between management and the audit committee;
- between outside auditors and the audit committee; and
- among the members of the audit committee without management or the outside auditors present.

In reliance on these conversations, the audit committee must state whether it believes that the company's financial statements are fairly presented in conformity with Generally Accepted Accounting Principles ("GAAP") in all material respects.

The Committee's hope is that the formal disclosures will assure the public that the audit committee is maintaining accountability. The Committee recommends that these disclosures also be

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[12/] AU Section 380, Communications With Audit Committees.

protected by an appropriate “safe harbor” provision.

Recommendation 10

The last recommendation is aimed at reducing the need for year-end “adjustments” for inaccuracies not detected during the previous three quarters. The recommendation is for the Commission to require that an outside auditor conduct an interim financial review prior to Form 10-Q filings. The interim review would be in compliance with Statement on Auditing Standards (“SAS”) 71. The Committee notes that the Big Five accounting firms recently required their clients to implement such procedures as a condition to their audit engagements.

The Committee further recommends that SAS 71 be amended to require that, prior to a Form 10-Q filing, the outside auditor also discuss with the audit committee, or its chairman, and a representative of financial management, the matters described in AU Section 380, Communications With Audit Committees. The topics discussed would include accounting policies, judgments, estimates, audit adjustments, disagreements with or delays caused by management, consultation with other accountants, and issues discussed prior to retention.

Conclusion

These recommendations, if implemented, will clearly have a significant impact on corporate audit committees. The combination of more stringent independence requirements and increased interaction with and oversight over management and auditors could potentially improve financial management and reporting practices. However, the market motivations that tend to work against accurate financial reporting are not going to disappear. These recommendations could, therefore, result in a mere re-ordering of the flow of information within a company with no real impact on the quality or reliability of reports to the public. The proposal to mandate quarterly SAS 71 review for all public companies may prove controversial in light of the expense and time required for the reviews. Another significant issue will be whether the recommendations will result in greater liability being imposed upon audit committee members, impacting the willingness of qualified persons to serve. The provision of safe harbors for the disclosure of information could help to mitigate potentially greater liability, although these safe harbors may prove difficult to craft.

Adoption of the recommendations in some form is highly probable. What is unknown at this time is the final format of any such provisions.

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