

NOTES FROM COUNSEL

Blue Ribbon Panel sends wake up call to sleepy audit committees

By W. Andrew Jack, Esq., Covington & Burling, Washington, D.C.

The Panel recommends changes in SEC regulations, auditing standards, and stock exchange listing rules designed to spur enhanced audit committee oversight of public financial reporting.

On February 8, 1999, an eleven-member Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (the Panel) issued a report detailing ten specific recommendations for changes in regulations affecting corporate audit committees and five guiding principles for audit committee "best practices." The Panel was organized in September 1998 as a joint effort of the Securities and Exchange Commission (SEC), the New York Stock Exchange (NYSE), and the National Association of Securities Dealers (NASD). It was formed in response to concerns voiced by SEC Chairman Arthur Levitt about the adequacy of audit process oversight by independent directors and related potential adverse effects on U.S. capital markets.

The Panel's proposals would direct that public companies establish new procedures to ensure the independence of auditors and audit committees from company management, promote professionalism and competence of audit overseers, and provide broader public

disclosure of audit committee responsibilities and activities. Although recommended changes to SEC regulations, NYSE and NASD requirements, and generally accepted auditing standards (GAAS) may become mandatory, the Panel encourages audit committees to voluntarily implement its improvement recommendations before regulators take action.

Recognizing that certain recommendations may be burdensome for smaller companies, the Panel intends that the first three (see list under "Ten regulatory recommendations") only be applied to companies with market capitalizations exceeding \$200 million. Newly proposed mandatory disclosures would fall under the same "safe harbor" that currently exempts compensation committee reports from securities fraud liability without proof of scienter. The Panel disavows any intent that the proposed disclosure requirements impose any greater liability on directors under state law, but does not address what impact its proposals might have on state

law fiduciary duty jurisprudence generally. Notably, the Panel does not recommend any new director signature or certification requirements for quarterly reports such as those proposed in the SEC's recent "aircraft carrier" release.

Ten regulatory recommendations

The Panel calls for the following regulatory changes:

1. New definition of independent director. Revise NYSE and NASD director independence definitions to require that (except in limited disclosed circumstances determined by the board) audit committee members be considered independent only if they do not have any of the following relationships to a company:

- being employed by the company or any of its affiliates for the current year or any of the past five years
- accepting any compensation from the company or any of its affiliates other than compensation for board service or benefits under a tax-qualified retirement plan
- being a member of the immediate family of an individual who is, or has been in any of the past five years, an executive officer of the company or any of its affiliates
- being a partner in, or a controlling shareholder or an executive officer of, any business organization to which the company made, or from which the company received, payments that are or have been significant to the company or business organization in any of the past five years, or
- being employed as an executive of another company where any of the subject company's executives serve on the other company's compensation committee.

2. Audit committee comprised solely of independent directors. Amend NYSE and NASD listing criteria to require that audit committees of listed companies be comprised solely of directors meeting the new independence standard.

3. Minimum of three directors who are financially literate. Revise NYSE and NASD rules to require that listed companies have audit committees comprised of a minimum of three directors, each of whom is financially literate (*i.e.*, able to read and understand basic financial statements), and that at least one member of the audit committee have accounting or related financial management expertise.

4. Written committee charter detailing responsibilities and duties. Establish new NYSE and NASD rules requiring the audit committee of each listed company to:

- adopt a formal written charter that is approved by the board of directors and that specifies the scope of the committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements, and
- review and reassess the charter's adequacy on an annual basis.

5. Annual reporting of audit committee activities. Promulgate new SEC rules that would require each reporting company to disclose:

- annually in its proxy statement whether the audit committee has adopted a formal written charter, and, if so, whether the committee satisfied its responsibilities during the prior year in compliance with its charter, and
- at least every third year, and after any significant amendment, the text of the committee charter.

6. Clarify oversight responsibility for engagement of outside auditor. Establish new NYSE and NASD rules requiring that audit committee charters for every listed company state that the outside auditor is ultimately accountable to the board of directors and the audit committee as representatives of shareholders, and, as such, the board and audit committee have ultimate authority and responsibility to select, evaluate, and where appropriate, replace the outside auditor.

7. Confirmation of outside auditor independence. Create NYSE and

NASD rules requiring that every listed company specify in its audit committee charter that the committee is responsible for confirming the independence of the company's outside auditors through appropriate actions, including obtaining a formal written statement describing all relationships between the auditor and the company. (Last month the SEC/American Institute of CPAs Independent Standards Board established a

**Recognizing that no
single set of "best
practices" is appropriate
for all companies, the
Panel offered five
guiding principles.**

new rule requiring that auditors provide such information to audit committees commencing with audits of fiscal years ending after July 15, 1999.)

8. Qualitative assessment of financial reporting. Modify GAAS to require that a company's outside auditor discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting; including such issues as the clarity of the company's financial disclosures and degree of aggressiveness or conservatism of the company's accounting principles and underlying estimates.

9. Annual audit committee letter to shareholders. Amend SEC rules to require all reporting companies to include a letter from the audit committee in the company's annual report to shareholders and Form 10-K disclosing whether or not, with respect to the prior year:

- management has reviewed the audited financial statements with the audit committee, including a discussion of the quality of the accounting principles as applied and significant judgments affecting the company's financial statements

- the outside auditors have discussed with the audit committee the outside auditors' judgments of the quality of those principles as applied and judgments referenced above under the circumstances
- the audit committee members have discussed among themselves, without management or the outside auditors present, the information disclosed to the audit committee by management and the outside auditors described above, and
- the audit committee, in reliance on the review and discussions conducted with management and the outside auditors, believes that the company's financial statements are fairly presented in conformity with generally accepted accounting principles in all material respects.

10. Interim review of quarterly financial reporting. Amend SEC rules to require that a reporting company's outside auditor conduct an SAS 71 (Statement on Audit Standards No. 71) interim financial review prior to the company's filing of its Form 10-Q. Amend SAS 71 to require that a reporting company's outside auditor discuss with the audit committee, or at least its chairman, and a representative of financial management, the matters described in SAS 61—communications with the audit committee—prior to the filing of the Form 10-Q. This discussion should include significant adjustments, management judgments and accounting estimates, significant new accounting policies, and disagreements with management.

Five guiding principles to set company specific "best practices"

In addition to specific regulatory recommendations, the Panel encouraged the development of "best practices" for audit committees. Recognizing that no single set of "best practices" is appropriate for all companies, the Panel offered five guiding principles (paraphrased below) for audit committees to follow in developing their own specific processes and policies:

1. Audit committee primacy in collaboration with other stakeholders.

Proper financial reporting demands a collaborative effort of management, internal auditors, external auditors, and the audit committee. However, as the representative of the board and shareholders, audit committees are “first among equals” with ultimate oversight responsibility for ensuring that each of the other financial reporting actors properly performs its duties.

2. Vigorous internal audit. To promote the efficacy of a company’s internal audit function, audit committees must establish a culture and procedures that encourage free and independent information flow between the committee and the internal auditors.

3. Independent external audit. Similarly, audit committees must confirm outside auditor independence and provide avenues for free and unfettered communications between outside auditors and the committee.

4. Careful assessment of qualitative variables. Audit committees must cultivate a frank dialogue with auditors and management to evaluate qualitative judgments with respect to major variables that affect financial reporting such as selection or change of accounting principles, relative aggressiveness/conservatism of reporting, significant estimates used in reporting, and methods of risk assessment.

5. Diligent and knowledgeable performance. Audit committee members must be diligent and knowledgeable, and devote sufficient time to do the job well.

What should a public company do?

The Panel views its recommendations as “an integrated set of objectives that must be adopted in its entirety in order to accomplish the intended results.”

Companies should assess
whether implementing
the Panel’s recommendations
would pose any hardship and
consider communicating any
concerns to the APTC.

However, it seems unlikely that the Panel’s recommendations will be adopted verbatim given the multiple actions that would be required by at least four different sets of regulators.

Despite the uncertain regulatory outcome, a completely passive, “wait and see” approach is probably not in the best interests of any public company. At a minimum, audit committee members, corporate secretaries, and senior financial management and reporting

personnel should become familiar with the Panel’s recommendations. They also should assess whether implementing any of the Panel’s recommendations would pose a hardship and consider communicating any concerns to APTC or other industry groups such as the American Society of Corporate Secretaries in anticipation of public comment opportunities on any relevant rulemaking.

Finally, those responsible for financial reporting might take this occasion to review and consider how to improve their company’s financial reporting practices and oversight functions in light of the Panel’s guiding principles. Adding this topic to the agenda of the next audit committee meeting, seeking reactions from external auditors, and reexamining the audit committee charter—or, lacking a charter, creating one—are all reasonable steps that should be considered. ■

W. Andrew Jack is of counsel in the law firm of Covington & Burling in Washington, D.C. Telephone: 202-662-5232; e-mail: ajack@cov.com. Reprinted with permission of the publisher, the Association of Publicly Traded Companies, 1200 G Street, NW, Washington, D.C. 20005.

The full text of the report is available on the internet at www.nyse.com and www.nasd.com.