

## SEC PROPOSED RULE CHANGES ON THE ROLE OF CORPORATE AUDIT COMMITTEES

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On October 6, 1999, the Securities and Exchange Commission (the "SEC") issued a release<sup>1</sup> (the "Release") proposing new requirements for corporate audit committees intended to improve disclosure relating to the functioning of corporate audit committees and enhance the reliability and credibility of financial statements of public companies. The proposals are based in a large part on recent recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees.<sup>2</sup> The committee consisted of business, accounting and securities professionals. The proposals are subject to public comment on or before November 29, 1999. The SEC may, after such period, adopt the proposals or make additional proposals based on comments received.

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### EXECUTIVE SUMMARY

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The proposed changes set forth in the Release are summarized below and would:

- require that companies' independent auditors review financial information included in their quarterly reports (Form 10-Q or 10-QSB) before those reports were filed with the SEC;
- require companies to include their audit committee reports in their proxy statements. The report must state whether the audit committee has (i) reviewed and discussed the financial statements with management, (ii) discussed certain matters with the independent auditors and (iii) received certain information from the auditors as to the auditors' independence and discussed the independence of the auditors with the auditors;
- require that the audit committee report also state whether anything has come to the attention of the audit committee that caused the audit committee to

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<sup>1</sup> SEC Release No. 34-41987 (October 6, 1999).

<sup>2</sup> See Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (the "Blue Ribbon Committee") (1999). The report is available on the Internet at: <http://www.nyse.com>, <http://www.amex.com> and <http://www.nasdaq.com>.

- believe that the company's audited financial statements included in the company's annual report (on Form 10-K or 10-KSB) contained an untrue statement of material fact or omitted to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading;
- require companies whose securities are listed on The New York Stock Exchange (the "NYSE") or The American Stock Exchange (the "AMEX") or quoted on Nasdaq to disclose in their proxy statement certain information about any director on the audit committee that is not "independent" as defined by the applicable self-regulatory organization<sup>3</sup> ("SRO"). All other companies must disclose whether the members of their audit committee, if they have an audit committee, are independent based on the definition of "independent" established by a SRO and also disclose which SRO definition of independence was used; and
  - establish "safe harbors" for information required to be disclosed under the proposal to protect companies and their directors from certain federal securities law liabilities.

#### PRE-FILING REVIEW OF QUARTERLY FINANCIAL STATEMENTS

Under current SEC rules, interim financial statements contained in a company's quarterly reports (Form 10-Q or 10-QSB) do not need to be reviewed or audited by independent auditors prior to filing those reports with the SEC. The Release proposes that interim financial statements be reviewed prior to filing with the SEC.<sup>4</sup> The SEC has not proposed that interim

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<sup>3</sup> The listing standards of the NYSE, AMEX and National Association of Securities Dealers, Inc. (the "NASD") are available on their websites at: <http://www.nyse.com>, <http://www.amex.com> and <http://www.nasdaq.com>. Each of the SRO's has filed proposed rule changes with the SEC regarding their listing standards as such standards relate to audit committees. See Proposed Rule Change, NYSE, File No. SR-NYSE-99-39, Proposed Rule Change, AMEX, File No. SR-AMEX-99-38 and Proposed Rule Change, NASD, File No. SR-NASD-99-48. The significant amendments proposed by the NYSE, AMEX and NASD include: (i) a more demanding definition of "independence" for audit committee members, (ii) a requirement that the audit committee consist of at least three "independent" members who are "financially literate," (iii) a requirement that at least one member of the audit committee has accounting or related financial management experience and (iv) a requirement that companies adopt a written audit committee charter that specifies the responsibilities of the audit committee. "Financially literate" would be determined by the board of directors under the proposed NYSE listing requirements while the AMEX and NASD require that the audit committee members be able to read and understand financial statements, including the company's balance sheet, income statement and cash flow statement.

<sup>4</sup> The proposal would require amendments to Rule 10-01(d) of Regulation S-X and Item 310(b) of Regulation S-B. Five of the largest United States accounting firms have adopted policies to require

financial statements be audited. A review, under current auditing standards, means that auditors would be required to follow procedures set forth in Statement of Auditing Standards (“SAS”) No. 71 (“Interim Financial Information”). Such a review is limited to inquiries and analytical procedures concerning significant accounting procedures and does not require search and verification procedures. The objective of a review is to provide the auditors with a basis for reporting whether material modifications are required so that such interim financial statements conform with Generally Accepted Accounting Procedures (“GAAP”).<sup>5</sup>

Under current rules, a company is required to file a copy of its auditor’s report if the auditor has performed a review of interim financial statements. The Release does not propose to modify that requirement.

#### THE AUDIT COMMITTEE REPORT

The Release would require the audit committee to provide a report in the company’s proxy statement disclosing whether the audit committee has reviewed and discussed the audited financial statements with management, discussed certain matters with the independent auditors as required by SAS No. 61, as amended or modified,<sup>6</sup> and received the written disclosures and letters from the independent accountants required by Independence Standards Board Standard No.1 (“ISB Standard No. 1”), as modified or supplemented,<sup>7</sup> and discussed the auditor’s independence with the auditor.<sup>8</sup> If the company does not have an audit committee,

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their clients to have reviews of quarterly financial statements as a condition to the accounting firm accepting the audit. *See* Release at p. 4, para. 1.

- <sup>5</sup> For a more detailed discussion of the scope of a review as compared to an audit, see SAS No. 71, para. 9 (“Objective of a Review of Interim Financial Information”).
- <sup>6</sup> SAS No. 61 (“Communication with Audit Committees”) requires independent auditors to inform the audit committee of certain matters, including among others, (i) methods used to account for significant unusual transactions, (ii) the process used by management in formulating sensitive accounting estimates and the basis of the auditors’ conclusion as to the reasonableness of those estimates and (iii) disagreements with management over the application of accounting principles.
- <sup>7</sup> ISB Standard No. 1 generally requires, among other things, that an auditor (i) disclose to the audit committee (or the board of directors if there is no audit committee), in writing, all relationships between the auditor and its related entities and the company and its related entities that in the auditor’s professional judgment may reasonably be thought to bear on independence; (ii) confirm in the letter that, in its professional judgment, it is independent of the company within the meaning of the Securities Act of 1933, as amended (the “Securities Act”), and the Securities Exchange Act of 1934, as amended (the “Exchange Act”); and (iii) discuss the auditor’s independence with the audit committee.
- <sup>8</sup> The proposals would require a new Item 306 of Regulation S-K and S-B and Item 7(e)(3) of Schedule 14A.

the full board or a board committee with responsibilities similar to that of an audit committee would be responsible for the disclosure.

The proposal does not require disclosure of detailed deliberations between or among the audit committee, independent auditor or management. In addition, the proposal does not require the audit committee to take specific actions, adopt specific procedures, perform a review of the financial statements or have discussions with management or the independent auditors; however, if such a review or discussions do occur, the proposal requires that the existence of the review or discussions be disclosed.

The Release would also require the audit committee to state in its report contained in the company's proxy statement whether anything came to the audit committee's attention that caused it to believe that the audited financial statements included in the company's annual report contained any untrue statement of material fact or omitted to state a material fact necessary to make the statements made, in light of the circumstances under which they were made, not misleading.<sup>9</sup> The audit committee may base its statement on its review and discussions with the company's management and auditors. The proposed audit committee statement differs significantly from the statement suggested in the Blue Ribbon Committee's report which would have required the audit committee to state that the financial statements were "fairly presented in conformity with GAAP in all material respects."<sup>10</sup> Consequently, the members of the audit committee are relieved of knowing all of the nuances and requirements of GAAP.

#### AUDIT COMMITTEE CHARTERS

The current proposal would require companies to state in their proxy statements whether the audit committee is governed by a charter and, if such a charter exists, it would have to be included as an appendix to the company's proxy statement at least once every three years.<sup>11</sup> The proposal does not require the adoption of a charter or, if such charter is adopted, any statement about whether the audit committee has complied with the charter.<sup>12</sup>

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<sup>9</sup> The SEC has stated that it believes that requiring an audit committee report will not increase exposure to liability since the more informed an audit committee becomes through discussions with the company's auditors and management the more likely the "business judgment rule" will apply and provide protection. *See* Release, at 21.

<sup>10</sup> Blue Ribbon Report, *supra* note 7, at 35.

<sup>11</sup> *See* proposed new paragraph (e)(3) under item 7 of Schedule 14A.

<sup>12</sup> The NYSE, AMEX and NASD have proposed as part of their listing requirements that the audit committee adopt a charter approved by the entire board that sets forth the scope of the committee's responsibilities and how those responsibilities are carried out. *See* Proposed Rule Change, NYSE,

## DISCLOSURE OF THE INDEPENDENCE OF AUDIT COMMITTEE MEMBERS

Each of the NYSE, AMEX and NASD have proposed amendments to their listing standards regarding the “independence” of audit committee members.<sup>13</sup> Each of the NYSE, AMEX and NASD allow the appointment of one non-independent director under limited circumstances if the board of directors determines that membership by the individual on the audit committee is required in the best interest of the company and its shareholders, and the nature of the relationship and the reason for the board of directors’ determination is disclosed in the next annual proxy statement. The SEC has proposed parallel disclosure requirements upon the appointment of a non-independent director to the audit committee, namely that the nature of the relationship that makes the individual not independent and the reasons for the board of directors’ determination.<sup>14</sup>

Companies who are not listed on the NYSE or the AMEX or quoted on Nasdaq, including small business issuers, must disclose whether, if they have an audit committee, the members are independent within the meaning of the term as defined by either the NYSE, AMEX or NASD.

## PROPOSED SAFE HARBORS

The Release does not intend to subject companies or their directors to increased exposure to liability under federal securities laws or create new standards for directors to fulfill their duties under state law. The SEC has proposed “safe harbors” to cover the new disclosures.<sup>15</sup> The “safe harbors” track the treatment of compensation committee reports under Item 402 of Regulation S-K. Under the safe harbor, the additional disclosure would not be considered “soliciting material” filed with the SEC and therefore not subject to Regulation 14A or 14C or to liability under Section 18 of the Exchange Act, unless the company either requested that the audit report be considered soliciting material or incorporated it by reference into a document filed under the Securities Act or the Exchange Act.<sup>16</sup>

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File No. SR-NYSE-99-39, Proposed Rule Change, AMEX, File No. SR-AMEX-99-38 and Proposed Rule Change, NASD, File No. SR-NASD-99-48.

<sup>13</sup> See *supra*, note 3.

<sup>14</sup> Small business issuers are not required to comply with this requirement.

<sup>15</sup> See proposed paragraph (c) in proposed Item 306 of Regulation S-K and S-B and proposed paragraph (e)(v) of Schedule 14A.

<sup>16</sup> We have been advised by the staff of the SEC that the audit committee report will not be deemed to be incorporated by reference into a shelf-registration statement despite the fact that registration statement form provides that all documents filed pursuant to Sections 13(a), 13(c), 14 and 15(d) after the effective date of the registration statement are deemed to be incorporated by reference. According to the staff the incorporation by reference language needs to specifically mention the audit

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If you have any questions concerning the Release, please contact Vincent Pagano, Jr., Arthur Robinson or Mark Cresitello of this firm at 212-455-2000.

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committee report for the report to be incorporated by reference. The staff intends to include clarifying language to this effect in the adopting release.