

**THE INS AND OUTS OF  
AUDIT COMMITTEES  
IN THE POST-ENRON ERA**

**Prepared By**

**Michael M. Boone  
Haynes and Boone, LLP**

**And**

**Gregory R. Samuel  
Haynes and Boone, LLP**

**February 20, 2003**

**25<sup>th</sup> Annual Conference  
On Securities Regulation  
And Business Law Problems  
Dallas, Texas**

**Sponsored by the University of Texas School of Law,  
Securities and Exchange Commission  
And Texas State Securities Board**

## TABLE OF CONTENTS

1.	INTRODUCTION .....	1
	1.1 <i>Scope Of Outline</i> .....	1
	1.2 <i>New Role Of Legal Counsel For Audit Committees</i> .....	1
2.	POST-ENRON REGULATORY REFORMS FOR CHANGING THE WAY CORPORATE AMERICA OPERATES .....	1
	2.1 <i>Key Regulatory Reforms</i> .....	1
	2.2 <i>Key Paradigm Change In Corporate Governance Under The New Regulatory Reforms</i> .....	3
3.	DUTIES AND AUTHORITY OF AUDIT COMMITTEES UNDER THE NEW REGULATORY SCHEME .....	3
	3.1 <i>Overview</i> .....	3
	<b>COMMITTEE PURPOSES AND AUTHORITY .....</b>	<b>4</b>
	3.2 <i>Committee Purpose</i> .....	4
	3.2 <i>Authority To Hire, Terminate And Compensate External Auditor</i> .....	4
	3.3 <i>Authority To Retain Independent Advisors</i> .....	5
	<b>COMMITTEE RESPONSIBILITIES FOR ACCOUNTING ISSUES .....</b>	<b>5</b>
	3.4 <i>Duty To Resolve Disputes Between The External Auditor And Management</i> .....	5
	3.5 <i>Duty To Review Reports From The External Auditor Concerning Accounting Issues</i> .....	6
	3.6 <i>Duty To Review Internal Controls And Disclosure Controls And Procedures</i> .....	7
	3.7 <i>Duty To Review Financial Statements And MD&amp;A Disclosures</i> .....	7
	3.8 <i>Duty To Consider Policies For Earnings Press Releases And Earnings Guidance</i> .....	8
	<b>COMMITTEE MONITORING OF THE EXTERNAL AUDITOR .....</b>	<b>8</b>
	3.9 <i>Duty To Pre-Approve All Audit and Non-Audit Services Of The External Auditor</i> .....	8
	3.10 <i>Duty To Review Soundness Of The External Auditor’s Internal Quality-Control Procedures</i> .....	9
	3.11 <i>Duty To Establish Hiring Policies Regarding Employees Or Former Employees Of The External Auditor</i> .....	9
	<b>COMMITTEE RESPONSIBILITIES FOR RISK MANAGEMENT .....</b>	<b>10</b>
	3.12 <i>Duty To Review Risk Management Policies</i> .....	10
	<b>COMMITTEE INTERFACE WITH KEY PERSONS.....</b>	<b>10</b>
	3.13 <i>Duty To Establish</i> .....	10
	3.14 <i>Duty To Meet In Executive Session With Key People Involved In The Internal And External Audit Functions</i> .....	11
	3.15 <i>Duty To Approve All Related Party Transactions</i> .....	11
	3.16 <i>Duty To Report Regularly To The Board Of Directors</i> .....	11
	<b>PERFORMANCE REVIEW .....</b>	<b>12</b>
	3.17 <i>Duty To Make An Annual Self-Evaluation Of The Audit Committee’s Performance</i> .....	12

4.	AUDIT COMMITTEE MEMBERSHIP REQUIREMENTS UNDER THE NEW REGULATORY SCHEME .....	12
4.1	<i>Number Of Members</i> .....	12
4.2	<i>Independence Requirements</i> .....	12
4.3	<i>Financial And Accounting Expertise Requirements</i> .....	13
5.	DIRECTOR LIABILITY ISSUES RELATING TO AUDIT COMMITTEE CONDUCT UNDER THE NEW REGULATORY SCHEME .....	15
5.1	<i>Delaware General Corporation §141(c)</i> .....	15
5.2	<i>Delaware General Corporation Law §141(e)</i> .....	16
5.3	<i>SOA Safe Harbor Rule For</i> .....	16
6.	DRAFTING AUDIT COMMITTEE CHARTERS UNDER THE NEW REGULATORY SCHEME.....	16
6.1	<i>Written Charter</i> .....	16
6.2	<i>Key Elements Of An Audit Committee Charter</i> .....	16
7.	CONCLUSION.....	20

## 1. INTRODUCTION

- 1.1. *Scope Of Outline.*** To restore confidence in the capital markets in the aftermath of Enron and other major corporate failures, the U.S. Congress and the major stock exchanges have crafted new regulations for the purpose of improving corporate governance, the integrity of financial statements and disclosures, the ethics of Corporate America, the responsibility of executive management for corporate disclosures, the independence and performance standards of auditors and the standards of conduct of lawyers and securities analysts as participants in the capital markets. The centerpiece of these regulatory reforms is the expansion of the role of audit committees. This outline focuses on those reforms that most impact the way audit committees operate. This outline does not address the impact of these reforms on foreign issuers.
- 1.2. *New Role Of Legal Counsel For Audit Committees.*** The new regulatory scheme imposes a significantly greater responsibility on audit committees. It comes as no surprise that boards of directors and audit committees are relying upon corporate lawyers for guidance in order to comply with the new regulations. Drafting committee charters and adopting appropriate operating procedures is definitely the current order of the day for corporate lawyers advising audit committees. While this represents significant work, it is very likely that after the current start-up period under the new regulatory reforms, audit committees will increasingly turn to legal counsel for advice as they seek to perform their expanded responsibilities. We can, however, expect audit committees to seek much of this advice from someone other than the company's in-house counsel or its regular outside corporate law firm. Independent legal counsel to audit committees will likely become a niche practice for law firms just as "special committee" work has become.

## 2. POST-ENRON REGULATORY REFORMS FOR CHANGING THE WAY CORPORATE AMERICA OPERATES

### 2.1. *Key Regulatory Reforms.*

- A. *Sarbanes-Oxley Act Of 2002 ("SOA").*** Signed into law by President Bush on July 30, 2002, the SOA is a legislative effort to restore confidence in the capital markets by curing the perceived problems behind the Enron failure and other major corporate failures. This federal legislation is extremely aggressive even to the point of encroaching into areas that were once considered to be only within the purview of state corporation laws.
- B. *Securities And Exchange Commission ("SEC") Rules And Regulations Implementing The Provisions Of SOA.*** The SOA requires that the SEC adopt rules to implement several of its regulatory reforms. So far the SEC has finalized and adopted rules covering the following ten matters:
- (i) CEO and CFO certifications;
  - (ii) Non-GAAP financial information;

- (iii) Code of ethics for senior management;
- (iv) “Audit Committee Financial Experts;”
- (v) Insider trading during pension plan blackout periods;
- (vi) Disclosure of material off-balance sheet transactions and contractual obligations;
- (vii) Retention of audit records;
- (viii) External auditor independence standards;
- (ix) Standards of conduct for attorneys; and
- (x) Expedited filing of Section 16 reports and Form 8-Ks containing earnings release information.

**C. *Corporate Governance Reforms Through The Listing Requirements Of The Organized Securities Markets.*** The NYSE and NASDAQ also have proposed new governance requirements for listed companies that impact the function of audit committees. These proposals were submitted in the late summer and early fall of 2002 to the SEC for its review and approval. However, given its demanding schedule in meeting SOA deadlines for adopting new rules and regulations, the SEC’s response to these proposed new listing requirements is not expected before the fall of 2003. Because the proposals of the NYSE and NASDAQ differ in many respects, we anticipate the SEC will consider how they can be best harmonized with each other and with the SEC’s own rules affecting audit committees. The SEC has already stated that it will conform the rules of the SROs relating to independence of audit committee members.

This outline includes the proposed New York Stock Exchange Listing Requirements (“NYSE Proposed Rules”) and the proposed NASDAQ Stock Market Inc Listing Requirements (“NASDAQ Proposed Rules”) relating to audit committee functions. If adopted in their current form, NYSE and NASDAQ listed companies will have two years to comply with the NYSE Proposed Rules (although shorter 6 and 12 month compliance deadlines apply to select provisions of the rules) and one year to comply with the NASDAQ Proposed Rules, respectively. Neither the American Stock Exchange (“AMEX”) nor any regional exchanges have submitted similar rule proposals to the SEC.

Section 301 of the SOA directs the SEC to adopt a rule prohibiting national securities exchanges and national securities associations from listing any company that is not in compliance with the audit committee requirements of SOA. The SEC has clarified that issuers of securities traded only on the over-the-counter bulletin board market are not subject to the rules relating to Section 301 of the SOA. On January 17, 2003, the SEC issued for public comment its proposed rule implementing Section 301. This rule is required to become effective by April 26,

2003. The audit committee requirements of SOA are generally already included in the NYSE Proposed Rules and the NASDAQ Proposed Rules.

***Observation:*** *The audit committee requirements of SOA are not generally applicable to private issuers with registered but unlisted public debt, although “best practices” concerning the implementation of disclosure controls may dictate establishment of such a committee. Furthermore, the “Big Four” accounting firms may require an independent audit committee as a pre-condition to their engagement for new issuers.*

**2.2. Key Paradigm Change In Corporate Governance Under The New Regulatory Reforms.** To fully appreciate the discussion below of the new role of audit committees, one should keep in mind that a primary goal of SOA and the NYSE and NASDAQ proposed changes in listing requirements relating to corporate governance matters (including the operations of audit committees) is to shift control from a company’s management to its independent directors. This point is perhaps best evidenced by two mandates contained in the NYSE Proposed Rules and the NASDAQ Proposed Rules: (i) independent directors would constitute a majority of the board (except in the case of controlled companies) and (ii) independent directors would control three key board committees (compensation, nominating and audit). Suffice it to say, the new regulatory reforms have markedly increased the responsibilities and power of independent directors. This new paradigm in corporate governance has been driven by the belief that independent directors will bring more objectivity to financial disclosures and the conduct of the external auditor than does management whose objectivity may be compromised by its focus on the economic performance of the company, particularly as it affects the stock price.

### **3. DUTIES AND AUTHORITY OF AUDIT COMMITTEES UNDER THE NEW REGULATORY SCHEME**

**3.1. Overview.** The recent failure of Enron and other major companies has been largely attributed to a breakdown in corporate governance and the external audit function. In particular, many perceive that auditor independence and objectivity in reporting on company financial statements was undermined by “less than arms-length relationships” between the external auditors and company management teams. In searching for a remedy to these problems, the role of the audit committee became the primary focus of SOA. Likewise, to strengthen the effectiveness of audit committees, the NYSE and the NASDAQ saw a need to adopt new listing requirements that would address Enron-type problems. Sections 3.2-3.18 below discuss these new duties and authority.

***Observation:*** *Prior to SOA, the regulation of audit committees has been traditionally left to state corporation law and the rules of the stock exchanges and national securities associations. SOA has “federalized” certain critical audit committee functions. Compared to SOA, however, the listing requirements of the NYSE and NASDAQ go further in expanding the authority and responsibilities of audit committees.*

## **COMMITTEE PURPOSES AND AUTHORITY**

### **3.2. *Committee Purpose.***

- A. *SOA.*** The federal securities laws do not directly spell out the purposes of an audit committee. However, in defining the term “audit committee,” Section 2(a)(3) of SOA states that it is a board committee charged with “overseeing the accounting and financial reporting processes of the [company] and audits of the financial statements” of the company. If no such board committee exists, Section 2(a)(3) provides that the audit committee is deemed to be the entire board of directors. It is doubtful that very many companies having listed equity securities will elect not to have an audit committee. Furthermore, both the NYSE Proposed Rules and the NASDAQ Proposed Rules require the establishment of an independent audit committee.
- B. *Listing Requirements.*** Section 303A(7)(b)(i) of the NYSE Proposed Rules states that at a minimum, the purpose of an audit committee is to oversee:
- (i) the integrity of the company’s financial statements;
  - (ii) the company’s compliance with legal and regulatory requirements;
  - (iii) the independent auditor’s qualifications and independence; and
  - (iv) the performance of the company’s internal audit function and its external auditor.

Most audit committees also oversee the company’s risk management processes. Another purpose is to prepare the audit committee report that the SEC requires to be included in the company’s annual proxy statement. The NASDAQ Proposed Rules do not specifically address the purposes of the audit committee.

### **3.2. *Authority To Hire, Terminate And Compensate External Auditor.***

- A. *SOA.*** Section 301 (amending Section 10A of the Securities Exchange Act of 1934) provides that the audit committee is to be “directly responsible” for the hiring, firing and compensation of the company’s external auditor.
- B. *Listing Requirements.*** Section 303A(7)(a) of NYSE Proposed Rules provides that the audit committee has the “sole authority” to hire and fire the external auditor and Section 303A(7)(b)(ii)(A) provides that it is the duty of the audit committee to retain and terminate the external auditor (subject, if applicable, to shareholder approval). NASDAQ Proposed Rule 4350(d)(1)(C)(ii) simply adopts the requirements of Section 301 of SOA.

***Observation:*** *SOA and the NYSE Proposed Rules in essence override state corporation law by removing from the boards of directors all authority with respect to the hiring and firing of the external auditor. Bottom line, the external auditor now*

*has a “new boss” – the audit committee. The external auditor must answer to the audit committee rather than to management or for that matter, to the whole board of directors. This change is intended to create an arms-length relationship between management and the external auditor and to bring greater objectivity to external auditor conduct and financial disclosures. Independent directors serving on the audit committee are expected to be more objective (i) in assuring that the external auditor is truly “independent” and qualified to perform the audit and (ii) in listening to the external auditor when it challenges accounting policies, practices or disclosures advocated by management.*

*In furtherance of the independent authority of the audit committee, Section 301 of SOA requires that the company provide funding, as determined by the audit committee, for payment of the services of the external auditor and any independent advisors retained by the committee (see Section 3.4 below).*

### **3.3. Authority To Retain Independent Advisors.**

**A. SOA.** Section 301 requires that the audit committee be given the authority to hire, at the company’s expense, their own independent advisors (such as lawyers and forensic accountants) needed to carry out the committee’s duties.

**B. Listing Requirements.** The commentary to Section 303A(7)(b)(ii)(E) of the NYSE Proposed Rules provides that the audit committee is “empowered to retain”, without board approval, independent advisors needed in fulfilling its duties. NASDAQ’s Proposed Rule 4350(d)(1)(C)(iii) simply adopts the requirements of Section 301 of the SOA.

***Observation:*** *As noted above, audit committees have been given substantial power and authority to act independently of management and even the board of directors. The authority to obtain independent advisors enables each audit committee to obtain a “second doctor’s opinion,” when the circumstances warrant it in the committee’s judgment and to generally obtain assistance in performing its expanded duties. The audit committee’s new authority parallels that of independent special committees established to handle conflicts of interest transactions. For that reason, an audit committee should assure that its advisors are truly independent.*

## **COMMITTEE RESPONSIBILITIES FOR ACCOUNTING ISSUES**

### **3.4. Duty To Resolve Disputes Between The External Auditor And Management.**

**A. SOA.** Under Section 301, the audit committee is charged with the duty of resolving disputes between the external auditor and management over issues pertaining to financial reporting. The insertion of independent directors directly into such disputes is intended to bring more objectivity and scrutiny to such disputes.

**B. Listing Requirements.** Section 303A(7)(b)(ii)(H) of the NYSE Proposed Rules requires the audit committee to review with the external auditor any difficulties that it encounters in the course of its audit work including restrictions on the scope of its activities and significant disagreements with management. The NASDAQ Proposed Rules have no comparable requirement.

***Observation:*** *There is no doubt that under the new regulatory scheme audit committees are expected to adopt a “hands on” approach in overseeing accounting issues. Duties relating to accounting issues, internal controls and financial disclosures (described in Sections 3.5 through 3.10) are not to be taken lightly. Audit committees will need to adopt appropriate procedures for carrying out these duties.*

*In case of major disputes between the external auditor and management, the external auditor is now expected to turn to the audit committee for a hearing rather than succumb to the pressure of management. The audit committee may encounter disputes that call for the committee to obtain independent advisors for a second opinion. In handling such disputes, audit committees members as well as management should be careful to not improperly influence the external auditor in violation of Section 303 of SOA.*

### **3.5. Duty To Review Reports From The External Auditor Concerning Accounting Issues.**

**A. SOA.** Section 204 (amending Section 10A of the Securities Exchange Act of 1934) requires that the external auditor “timely report to the audit committee:”

- (i) critical accounting policies and practices to be used by the company;
- (ii) alternative accounting treatments under generally accepted accounting principles discussed with management, the ramifications of those alternatives, and external auditing preference; and
- (iii) other material communications to management such as a “management letters.”

**B. Listing Requirements.** There are no comparable requirements in the NYSE Proposed Rules or NASDAQ Proposed Rules.

***Observation:*** *Needless to say, the requirements of Section 204 are in response to the perception that the board of Enron failed to appreciate the implications of certain accounting transactions adopted by management and accepted by the external auditor. Clearly, the audit committee is expected to objectively weigh the information provided in the report of the external auditor and the soundness of the company’s critical accounting policies.*

### **3.6. *Duty To Review Internal Controls And Disclosure Controls And Procedures.***

**A. SOA.** Under Section 302, the chief executive officer (“CEO”) and the chief financial officer (“CFO”) are required to certify to the SEC in each annual report on Form 10-K (“10-K”) and each quarterly report on Form 10-Q (“10-Q”) as to its correctness. In addition, each certification must confirm that the CEO and CFO (i) are responsible for the company’s internal controls, (ii) have designed such controls to ensure that such officers have knowledge of material corporate information, (iii) have evaluated the effectiveness of the internal controls within 90 days prior to the report and (iv) have set forth on the report their conclusions about the effectiveness of such controls. Section 404 directs the SEC to adopt rules requiring (i) companies to include in their Form 10-K an internal control report confirming the management’s responsibility for internal controls and an assessment, as of year-end, of the effectiveness of the internal control structure and procedures and (ii) external auditors attestation to such internal control report.

Also, Section 302 requires that the signing officers state in the report that they have disclosed to the external auditor and the audit committee (i) all significant deficiencies in the internal controls and (ii) any fraud, whether or not material, involving management or other employees.

Intertwined with the CEO’s and CFO’s certification as to internal controls is the requirement in SEC Rules 13a-14 and 15d-14 that they also certify as to the existence and effectiveness of the “disclosure controls and procedures” of the company. Accordingly, the audit committee is obliged to satisfy itself as to adequacy of, and compliance with, such disclosure controls and procedures. The company itself is required to conduct an evaluation before each periodic Exchange Act filing of the effectiveness of those controls with the participation of the company’s management, including the CEO and CFO.

**B. *Listing Requirements.*** No comparable requirements are included in the NYSE Proposed Rules or NASDAQ Proposed Rules.

***Observation:*** *As part of their oversight duties with respect to the integrity of financial disclosures, audit committees should take appropriate steps to scrutinize the processes underlying the Section 302 certifications of management. This generally means that they should be satisfied that there are reasonable “internal controls” and “disclosure controls and procedures” in place and that they are being followed in creating the basis for such certifications. Audit committees will continue to rely on input from the external auditor and the internal audit staff as to the reliability and functioning of internal controls and disclosure controls and procedures.*

### **3.7. *Duty To Review Financial Statements And MD&A Disclosures.***

**A. SOA.** No comparable requirement is in the SOA.

**B. Listing Requirements.** Section 303A(7)(b)(ii)(C) of NYSE Proposed Rules would require the audit committee to review and discuss with management and the external auditor the company’s annual audited financial statements and its quarterly financial statements along with the company’s Management’s Discussion and Analysis of Financial Conditions and Results of Operations (“MD&A”). The NASDAQ Proposed Rules have no comparable requirement.

***Observation:*** MD&A is a key disclosure component of the federal securities regulatory scheme. The SEC rules governing MD&A have been a work-in-progress for many decades. Essentially, it is management’s narrative explanation of the financial statements for the purpose of enabling the capital markets to better assess the company’s financial statements, condition and operations. The SEC desires MD&A to provide investors the opportunity to see the Financial Statements “through the eyes of management.” Moreover, it calls for management to discuss “known trends and uncertainties” that it believes may materially affect the financial condition of the company. The audit committee should be adequately versed in MD&A rules and requirements in order to fulfill its oversight duties.

**3.8. Duty To Consider Policies For Earnings Press Releases And Earnings Guidance.**

**A. SOA.** No comparable requirement is in the SOA.

**Listing Requirements.** Section 303A(7)(b)(ii)(D) of the NYSE Proposed Rules would set forth a duty on the part of the audit committee to discuss earnings press releases as well as earnings guidance provided to analysts and rating agencies. Presumably, this discussion is to be with management. The NYSE’s commentary to this rule makes it clear that this duty does not require a discussion prior to each issuance of a press release or an earnings guidance but instead it contemplates that the duty of an audit committee is to satisfy itself generally as to procedure and format for these disclosures. The NASDAQ Proposed Rules have no comparable requirement.

**COMMITTEE MONITORING OF THE EXTERNAL AUDITOR**

**3.9. Duty To Pre-Approve All Audit And Non-Audit Services Of The External Auditor.**

**A. SOA.** Under Sections 201 and 202 (amending Section 10A of the Securities Exchange Act of 1934), the audit committee is required to pre-approve all audit and non-audit services (except for de minimus services) provided by the company’s external auditor. Furthermore, Section 201 lists eight non-audit services (e.g., bookkeeping, internal audit outsourcing, and legal services) that external auditors are prohibited from providing to their audit clients. If a permitted non-audit service is approved, the audit committee must conclude that rendering such service would not adversely affect the objectivity and independence of the external auditor in performing the audit.

**B. Listing Requirements.** Section 303A(7)(a) of the NYSE Proposed Rules states that it is the responsibility of the audit committee to approve “any significant non-

audit relationship with the independent auditors” while NASDAQ Proposed Rule 4350(d)(1)(C)(i) simply adopts the requirements of Section 202 of SOA.

***Observation:*** *Audit committees should adopt appropriate procedures for granting on a timely basis approval for services of the external auditor. Section 202 permits an audit committee to delegate pre-approval authority to one or more of its members to achieve efficiency in the process.*

*Audit committees would be well advised to periodically obtain written confirmation from the external auditors (i) as to each separate service that it is providing the company and (ii) that the committee has granted its approval for each such service in writing prior to its commencement.*

### **3.10. Duty To Review Soundness Of The External Auditor’s Internal Quality-Control Procedures.**

**A. SOA.** No comparable requirement is in the SOA.

**B. Listing Requirements.** Section 303A7(b)(ii)(B) of NYSE Proposed Rules would require that at least annually, the audit committee evaluate the soundness of the internal quality-control procedures of the external auditor including any problems raised with them by any peer review or governmental or regulatory investigators during the prior five years and the external auditor’s response to those problems. The NASDAQ Proposed Rules have no comparable requirement.

***Observation:*** *The Public Company Accounting Oversight Board (“PCAOB”), established under Section 101 of SOA, is responsible for overseeing the audit of public companies. Its duties include creating quality control standards for auditing firms and conducting inspections of such firms to determine whether they are in compliance with the rules of the PCAOB. Accordingly, to evaluate the performance and quality of the external auditor, audit committees should periodically seek confirmation as to their external auditors’ internal quality controls, their standing before the PCAOB and the nature of any investigation or other proceedings relating to their quality controls or performance.*

### **3.11. Duty To Establish Hiring Policies Regarding Employees Or Former Employees Of The External Auditor.**

**A. SOA.** Section 206 of the SOA prohibits a registered public accounting firm from auditing a public company if the company’s CEO, CFO, controller or chief accounting officer was employed by and participated in the audit of that issuer during the one-year period preceding the date of initiating the audit.

**B. Listing Requirements.** Section 303A(7)(b)(ii)(I) of the NYSE Proposed Rules would require the audit committee to set hiring policies concerning employees or former employees of the external auditor “taking into account the pressures that may exist for auditors consciously or subconsciously seeking a job with the

company they audit.” The NASDAQ Proposed Rules have no comparable requirement.

***Observation:*** *Although an outright ban on the hiring of employees from the external auditor seems inadvisable given the experience and company knowledge these prospective employees have gained through the audit engagement, lesser measures and policies may be thoroughly tested by the desire to hire these individuals whose talents and skills are known to the internal staff.*

## **COMMITTEE RESPONSIBILITIES FOR RISK MANAGEMENT**

### **3.12. Duty To Review Risk Management Policies.**

- A. SOA.** No comparable requirement is in the SOA.
- B. Listing Requirements.** Section 303A(7)(b)(ii)(F) of the NYSE Proposed Rules would require that the audit committee discuss with management the company’s risk exposures and its policies for monitoring and controlling such exposures. The NASDAQ Proposed Rules do not have such a requirement.

***Observation:*** *While management is charged with risk management for the company, the audit committee still has a duty to monitor how management assesses risk issues and the procedures that it follows in managing such risks.*

## **COMMITTEE INTERFACE WITH KEY PERSONS**

### **3.13. Duty To Establish “Whistle-Blower” Policies.**

- A. SOA.** The audit committee is required by Section 301 to establish procedures for handling “whistle-blower” complaints received by the company regarding accounting, internal controls or auditing matters (including confidential, anonymous submissions by employees).

***Observation:*** *The procedures for handling complaints concerning accounting, internal controls and auditing matters may be incorporated into a company’s code of ethics. Typically, the written procedures relating to whistle-blower complaints on accounting related problems do the following:*

- (i) Set forth a statement about the company’s commitment to comply with laws including accounting matters;*
- (ii) Encourage employees to inform the company of conduct amounting to a violation of the applicable standards;*
- (iii) Describe prohibited conduct;*
- (iv) Set forth compliance procedures that employees can easily use including making anonymous complaints; and*

(v) *Provide assurances that there will be no retaliation for reporting suspected violations.*

**B. Listing Requirements.** While the NYSE Proposed Rules have no comparable requirement, Section 4350(d)(1)(C)(iv) of the NASDAQ Proposed Rules would require the audit committee to establish complaint procedures in parallel with the requirements of Section 301 of SOA.

**3.14. Duty To Meet In Executive Session With Key People Involved In The Internal And External Audit Functions.**

**A. SOA.** No comparable requirement is in the SOA.

**B. Listing Requirements.** Section 303A(7)(b)(ii)(G) of the NYSE Proposed Rules requires the audit committee, in performing its oversight functions, to meet separately with (i) management, (ii) the external auditor and (iii) the internal auditor. The NASDAQ Proposed Rules have no comparable requirement.

***Observation:*** *Section 303A(7)(c) of the NYSE Proposed Rules requires that a company establish an internal audit department. The internal audit function is key to an audit committee's ability to carry out its role. In addition to management, the external auditor and the internal auditor, the audit committee also should consider periodically meeting in executive session with the company's general counsel and outside law firm.*

**3.15. Duty To Approve All Related Party Transactions.**

**A. SOA.** The SOA does not require audit committee approval of related party transactions.

**B. Listing Requirements.** Section 4350(h) of the NASDAQ Proposed Rules would require audit committee approval of all related party transactions. Neither the NASDAQ Proposed Rules nor the existing NASDAQ rules define the term "related party transaction." The NYSE Proposed Rules have no comparable requirement.

**3.16. Duty To Report Regularly To The Board Of Directors.**

**A. SOA.** No comparable requirement is in the SOA.

**B. Listing Requirements.** Section 303A(7)(b)(ii)(J) of the NYSE Proposed Rules would require the audit committee to review with the full board any issues that arise with respect to the quality or integrity of the company's financial statements. The NASDAQ Proposed Rules have no comparable requirement.

***Observation:*** *Reporting to the full board should be done on a regularly scheduled basis and when special problems arise. In addition, the full board should receive a copy of the minutes of all audit committee meetings.*

## **PERFORMANCE REVIEW**

### **3.17. Duty To Make An Annual Self-Evaluation Of The Audit Committee's Performance.**

- A. SOA.** No comparable requirement is in the SOA.
- B. Listing Requirements.** NYSE Section 303A(7)(b)(iii) would require that annually audit committees must assess their own performance. The NASDAQ Proposed Rules have no comparable requirement.

***Observation:*** *Many companies use self-assessment questionnaires for evaluating board and board committee performance. Many boards of directors object to such questionnaires fearing that it will serve as "Plaintiff's Exhibit No. 1."*

## **4. AUDIT COMMITTEE MEMBERSHIP REQUIREMENTS UNDER THE NEW REGULATORY SCHEME**

### **4.1. Number Of Members.**

- A. SOA.** SOA does not have any requirement as to the number of audit committee members.
- B. Listing Requirements.** The NYSE and NASDAQ listing requirements each require the audit committee to have a minimum of three members.

### **4.2. Independence Requirements.**

- A. SOA.** Section 301 requires that all the members of the audit committee be "independent" directors, which means that an audit committee member (i) cannot receive any compensation payments from the company except for board or board committee service and (ii) cannot be an "affiliated person" of the company or any of its subsidiaries. As proposed by the SEC, the term "affiliated person" means "a person that directly, or indirectly ... controls, or is controlled by, or is under common control with, the person specified." The SEC proposal carves out from the "affiliated person" definition any person who (i) is not the beneficial owner, directly or indirectly, of more than 10% of any class of equity securities of the company and (ii) is not an executive officer or director of the company. A director, executive officer, partner, member, principal or designee of an "affiliate" is deemed to also be an "affiliate."
- B. Listing Requirements.** Under Section 303.01(B)(2)(a) of the NYSE Listed Company Manual, all audit committee members must be independent. Section 303A(2) of the NYSE Proposed Rules would provide that for a director to be deemed independent, the board must affirmatively determine that such person has no "material relationship" with the company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company). In the case of a former employee, there is also a "cooling off" period

of five years before that person can be considered to be independent. Additionally, to be considered “independent,” a person would not be able to receive any payments from the company other than director’s fees including regular benefits provided to directors. These fees may be paid in cash or company equity securities. The basis for a board determination that a director does not have a “material relationship” would have to be disclosed in the annual proxy statement. However, the NYSE Proposed Rules would allow for boards to adopt and disclose categorical standards for determining whether a director is independent.

***Observation:*** *The NYSE’s concept of categorical standards enables a company to disclose that all directors meet those standards without having to explain the basis for finding no “material relationship.”*

The NASDAQ Proposed Rules maintain the requirement that all audit committee members are to be “independent.” NASDAQ Proposed Rule 4200(A)(15) defines “independent director” to mean a person other than an officer or employee of the company or a subsidiary or any other person having a relationship which, in the opinion of the board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. This Rule identifies five categories of people who would not be considered to be independent. For instance, two of the categories are (i) persons employed by the company or affiliate during the prior three years and (ii) persons affiliated with a non-profit organization to which the company made, or from which the company received, payments that exceed 5% of the recipient’s gross revenues or \$200,000, whichever is more. NASDAQ Proposed Rule 4350(d)(2)(A) also would require that to be “independent,” an audit committee member must (i) meet the criteria for independence set forth in Section 301 of SOA and (ii) not own or control 20% or more of the company’s voting securities.

***Observation:*** *Lawyers, investment bankers and other consultants who directly or indirectly through their firms are paid by the company for their professional services would not be considered independent under either the NYSE Proposed Rules or the NASDAQ Proposed Rules.*

#### **4.3. Financial And Accounting Expertise Requirements.**

##### **A. SOA**

- (i) ***Determination And Disclosure.*** To bolster the effectiveness of audit committees in overseeing the integrity of financial statements and disclosures, Congress decided that it is desirable for audit committees to have at least one member who is familiar with how audit committees work, who has expertise in accounting matters and who has the ability to ask the right questions. Accordingly, Section 407 of the SOA directs the SEC to adopt a rule requiring a public company to disclose in its Form 8-Ks and 10-Qs whether it has at least one “audit committee financial

expert” on its audit committee and if not, why not. Under the rule, it is incumbent on a company to determine whether any member is an “audit committee financial expert” and if there is one, the company may not refuse to disclose that person’s name. Because the SOA is silent on the issue, the SEC has indicated in its adopting release that it believes the entire board of directors is left with the responsibility of determining who is an “audit committee financial expert.” The SEC believes “it is appropriate that any such determination will be subject to relevant state law principles such as the business judgment rule.” If the board determines that there is more than one “audit committee financial expert,” the company may, but is not required to, disclose such additional persons.

- (ii) ***Definition of “Audit Committee Financial Expert.”*** Under the SEC’s rule, “audit committee financial expert” is defined to mean a person who has the following five attributes:
  - (i) an understanding of GAAP and financial statements;
  - (ii) the ability to assess the general application of GAAP in connection with the accounting for estimates, accruals and reserves;
  - (iii) experience preparing, auditing, analyzing or evaluating financial statements of a breadth and level of complexity of accounting generally comparable to those that can reasonably be expected to be raised by the company’s financial statements, or experience actively supervising one or more persons engaged in such activities;
  - (iv) an understanding of internal controls and procedures for financial reporting; and
  - (v) an understanding of audit committee functions.

The rule further provides that such person must have acquired these five attributes through:

- (i) 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;
- (ii) experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;
- (iii) experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or

(iv) other relevant experience.

- (iii) ***Independence From Management Disclosure Requirement.*** If an “audit committee financial expert” is identified, the company must also disclose whether that person is “independent” as that term is used in Item 7(d)(3)(iv) of Schedule 14A. For registrants whose securities are listed on the NYSE, AMEX or quoted on NASDAQ, Schedule 14A directs these registrants to use the definition of “independence” set forth in Section 303.01(B)(2)(a) and (3) of the NYSE’s listing standards, Section 121(A) of the AMEX’s listing standards, or Rule 4200(a)(15) of the National Association of Securities Dealers (“NASD”) listing standards, as applicable and as may be modified or supplemented. Registrants, including small business issuers, whose securities are not listed on the NYSE or AMEX or quoted on NASDAQ, must use the definition of “independence” in Sections 303.01(B)(2)(a) and (3) of the NYSE’s listing standards, Section 121(A) of the AMEX’s listing standards or Rule 4200(a)(15) of the NASD’s listing standards, as such sections may be modified or supplemented, and state which of these definitions was used. Whichever definition is chosen must be applied consistently to all members of the audit committee.

**B. *Listing Requirements.*** While the concept of “audit committee financial expert” is absent in the NYSE Proposed Rules, the NYSE does currently require that each member of the audit committee be financially literate (or must become financially literate within a reasonable period of time after his or her appointment) and that at least one member of the committee have “accounting or related financial management expertise.” The NASDAQ Proposed Rule 4350(d)(2)(A)(ii) essentially adopts requirements of Section 407. NASDAQ also currently requires that all audit committee members be able to read and understand financial statements (or become able to do so within a reasonable period of time after appointment).

## **5. DIRECTOR LIABILITY ISSUES RELATING TO AUDIT COMMITTEE CONDUCT UNDER THE NEW REGULATORY SCHEME**

**5.1. *Delaware General Corporation §141(c).*** Under Delaware law, the business and affairs of a corporation are to be managed by its board of directors. However, Section 141(c) of the Delaware General Corporation Law (“DGCL”) states that a board may establish committees (pursuant to its bylaws or by a resolution of the board) to “exercise all the powers and authority of the board of directors in the management of the business and affairs” of the company except for making changes in the bylaws or taking certain actions with respect to matters that are required to be submitted to the stockholders for approval. SOA’s audit committee requirements are not directly imposed on companies. Instead, pursuant to Section 301 of SOA, the Self-Regulatory Organizations are required to make them conditions of being a listed company. For that reason, a board of directors must through the exercise of its authority under Section 141(c), establish an audit committee whose charter is

carefully crafted to conform to SOA and the applicable listing requirements for audit committees.

- 5.2. *Delaware General Corporation Law §141(e).*** Section 141(e) of the DGCL provides that a member of the board and members of board committees shall be “fully protected in relying in good faith upon the records of the corporation and upon such information, opinions, reports or statements presented to the corporation by any of the corporation’s officers or employees, or committees of the board” (emphasis added). Furthermore, such protection is equally afforded to such directors in relying in good faith on opinions and reports of other persons “as to matters the [director] reasonably believes are within such person’s professional or expert competence” and who was “selected with reasonable care.” Section 141(e) was amended in 1987 to its present form that expressly permits reliance on committees. No reported cases exist that address reliance upon committees. Case law concerning reliance on experts, however, can provide guidance about proper reliance by non-audit committee members on the audit committee.

***Observation:*** *Non-audit committee members of the board of directors would be well advised to not passively rely on the establishment of an audit committee to fulfill their duties to address the issues or potential issues that spawned the SOA. They should, at a minimum: (i) carefully select the members of the audit committee, (ii) be satisfied as to the independence of each member of the audit committee, and (iii) have reasonable grounds to believe that the audit committee is acting in accordance with its charter.*

- 5.3. *SOA Safe Harbor Rule For “Audit Committee Financial Experts.”*** Recently adopted rules implementing Section 407 of the SOA make clear that an “audit committee financial expert” is not an expert for the purposes of Section 11 of the Securities Act of 1933. Furthermore, this safe harbor rule provides that audit committee financial experts do not have duties or exposure to liabilities greater than those of their fellow audit committee members nor does the designation of audit committee financial expert affect the duties or liability of any other member of the audit committee or the board of directors.

***Observation:*** *Notwithstanding this safe harbor rule, will jurors hold a director designated as a “audit committee financial expert” to a higher standard than his or her fellow directors?*

## **6. DRAFTING AUDIT COMMITTEE CHARTERS UNDER THE NEW REGULATORY SCHEME**

- 6.1. *Written Charter.*** Existing NYSE and NASDAQ listing requirements mandate that a listed company to have a formal written charter delineating the duties and responsibilities of its audit committee.
- 6.2. *Key Elements Of An Audit Committee Charter.*** Below are the usual categories of topics covered in an audit committee charter and below each are the matters that will need to be addressed in the charter about that topic.

**A. *Statement of Purpose.***

- (i) Oversee the integrity of financial statements and disclosures.
- (ii) Oversee compliance with legal and regulatory requirements.
- (iii) Oversee the qualifications and independence of external auditor.
- (iv) Oversee the internal audit function.

**B. *Membership Composition.***

- (i) Number of members (including minimum number).
- (ii) Qualifications:
  - “Independence” requirement
  - “Audit Committee Financial Expert” requirements
  - “Financial Literacy” requirements
- (iii) Manner of appointment.
- (iv) Term of office.
- (v) Compensation restrictions.

**C. *Authority.***

- (i) Right to retain independent advisors.
- (ii) Right to pursue educational programs.
- (iii) Right to conduct independent investigations.
- (iv) Right to full access to employees and corporation information.

**D. *Meetings.***

- (i) Frequency.
- (ii) Executive sessions with key personnel and agents.
- (iii) Keeping minutes.
- (iv) Quorum requirement.
- (v) Agenda preparation.

- (vi) Presiding director.

**E. *External Auditor Oversight.***

- (i) Sole authority to select, retain, oversee, terminate, and evaluate the external auditor.
- (ii) Process for pre-approving audit and non-audit services of the external auditor.
- (iii) Process for assessing independence and qualifications of the external auditor.
- (iv) Process for assessing the internal quality controls of the external auditor.
- (v) Confirmation from the external auditor of required audit partner rotation.

**F. *Internal Auditing Function Oversight.***

- (i) Performance evaluation of internal audit staff.
- (ii) Process for planning and coordinating the company's internal audit program.
- (iii) Process for reviewing reports of the internal audit staff to management.

**G. *Financial Statements And Disclosure Oversight.***

- (i) Process for reviewing, prior to filing, all 10-Qs and 10-Ks and the procedures for issuing earnings releases and guidance.
- (ii) Process for reviewing and approving, before their implementation, all significant accounting changes.
- (iii) Process for periodically assessing the adequacy of the company's financial disclosures.
- (iv) Process for monitoring third-party criticisms of the company's financial statements and disclosures and for receiving and handling whistle-blower complaints.

**H. *Internal Controls And Legal Compliance Oversight.***

- (i) Process for periodically (x) assessing the adequacy and effectiveness of internal control systems and policies on compliance with laws and regulations and (y) reviewing the internal controls evaluation and any reports of fraud made by the CEO and CFO in their SEC certifications pursuant to SOA §302.

- (ii) Process for monitoring adequacy of information security systems.
- (iii) Process for monitoring allegations of misconduct by officers or directors.
- (iv) Process for monitoring any significant disagreements with outside legal counsel regarding public disclosures or other legal compliance issues.

**I. *Risk Management Oversight.***

- (i) Process for periodically reviewing major risk exposures and for assessing steps taken to monitor and control such risks.
- (ii) Process for periodically assessing insurance coverage.
- (iii) Process for periodically assessing all special-purpose entities, off-balance sheet transactions, commodity contracts with no quoted market price and related party transactions.
- (iv) Process for periodically receiving reports from legal counsel regarding significant unasserted and asserted legal claims and other risk management issues.

**J. *Making Reports And Assessments.***

- (i) Process for periodically reporting activities of the audit committee to the board of directors.
- (ii) Process for annually conducting an assessment of the audit committee charter.
- (iii) Process for conducting the annual self-assessment of the audit committee's performance.
- (iv) Process for preparing the audit committee report to be included in the company's proxy statement for its annual meeting.
- (v) Process for recommending action to the board of directors regarding the inclusion of the financial statements in the company's Form 10-K.
- (vi) Process for ensuring board of directors access to external auditor.

**K. *General Duties.***

- (i) Responsibility of management and the external auditor for the financial statements.
- (ii) Charter provisions serve as general guidelines for the audit committee in carrying out its oversight functions.

## **7. CONCLUSION**

The well-publicized corporate failures have led Congress to enact extensive legislation in a greatly expedited fashion. The NYSE and the NASD have reacted with similar speed and zeal. The ramifications of the SOA and its progeny will not be fully known for years.