

It's no longer business as usual for audit committee members and auditors.

NYSE Sets Audit Committees on New Road

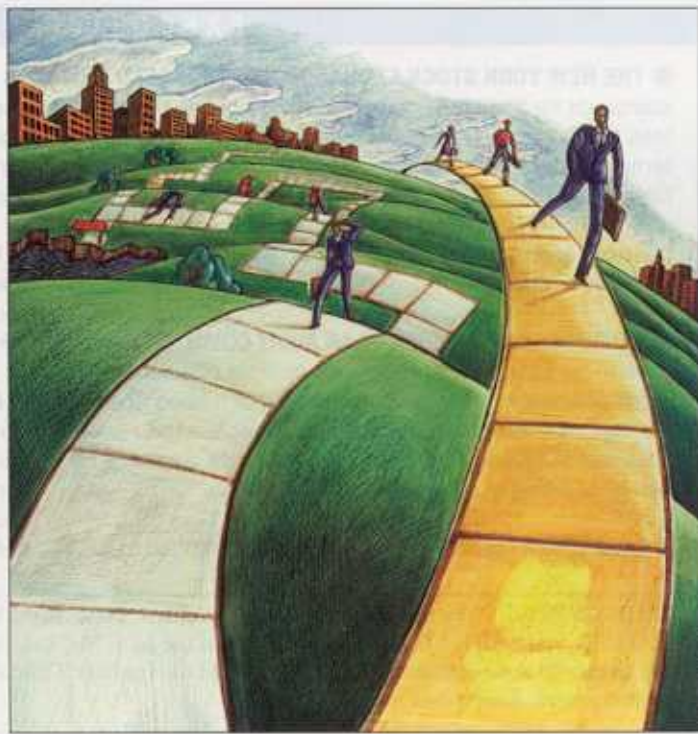
BY PAUL SWEENEY AND CYNTHIA WALLER VALLARIO

Headline-grabbing accounting scandals such as the ones at WorldCom, Adelphia Communications, Global Crossing and, of course, Enron, cost investors hundreds of millions of dollars and thousands of employees their jobs. Corporate financial executives, internal auditors, audit committee mem-

bers, external auditors—and all accounting professionals—need to be aware of the new corporate governance rules the New York Stock Exchange (NYSE) has proposed to help the audit committees and external auditors of companies listed on the Big Board address the weaknesses that led to accounting and corporate reporting failures.

As CPAs study and prepare to work with the proposed standards, which will provide better checks and balances for companies' financial reporting and audit oversight, they will have opportunities—as auditors in relationships with audit committees and as corporate governance advisers in both audit and nonaudit engagements—to help those companies evaluate their audit committee practices, effect improvements where necessary and promote policies to provide value for shareholders. And perhaps most important—because each member of an audit committee must be financially literate and at least one committee member must have accounting or related financial management expertise—CPAs can showcase their knowledge and skills, and contribute to an improved corporate culture, by agreeing to serve on these committees.

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RAISING THE BAR

On August 1, 2002, the NYSE's board of directors approved amendments to its listing standards and filed the proposed rules with the SEC on August 16; a public comment period must elapse before the commission votes and gives its final approval. The proposed rules are aimed at restoring investor confidence by enhancing company accountability and strengthening corporate governance. A key provision in the NYSE amendments would make a company's audit committee responsible for oversight of external auditors and give it sole authority to approve all audit engagement fees and terms, as well as all significant nonaudit engagements for the outside auditors. (The text of the proposal is available at www.nyse.com/about/report.) The amendments, which also include requirements for public companies and their directors that go beyond those aimed at audit committees, would appear in the NYSE manual for listed companies under "Corporate Governance Standards" (as new section 303A). In the meantime the Nasdaq filed rules similar to those of the NYSE and also awaits SEC approval. (For information on related regulations from Congress and the SEC, see "Regulations Under the Sarbanes-Oxley Act," *JofA*, Oct.02, page 33.)

Public Fed Up With Corporate Scandals

Public confidence in the reliability of companies' reported earnings reached historic lows, with 79% of Americans telling pollsters at CBS News in July that "questionable accounting practices are widespread." The survey also revealed two-thirds of the respondents believed corporate executives were not honest.

Source: CBS News Poll, July 2002. www.cbsnews.com



The proposed standards would affect all companies whose stocks trade on the NYSE and also business organizations in noncorporate forms, such as limited partnerships, business trusts and REITs (real estate investment trusts), subject to the exchange's jurisdiction. Existing audit committee requirements would apply during the transition to the new rules.

The proposed rules broaden the audit committee's authority with respect to the integrity of a company's financial statements and the independence of outside auditors—even though the audit committee does not certify the financial statements or guarantee the external auditor's report. Two significant requirements in the proposed NYSE listing standards address the independence of corporate boards of directors, from whose ranks the audit committees are drawn, and fee payment to audit committee members.

■ **A redefinition of the "independence" requirement.** The board of a listed company would be required to have a majority of independent directors, but all the members of the board's audit committee would have to be independent. (The audit committee would continue to have a minimum of three members.) The exchange tightened its definition of independent director: For an individual to qualify as in-

an audit committee composed of a minimum of three independent directors. The proposed rules require certain individuals to observe a five-year "cooling-off" period before they can serve on a corporate board and meet the independence requirements.

■ **DIRECTORS' FEES WOULD BE THE ONLY COMPENSATION** that an audit committee member could receive from the company. The existing NYSE rules for audit committees contain no such mandate.

■ **AUDIT COMMITTEES WOULD HAVE TO HAVE SEPARATE** sessions with management, external auditors and those responsible for internal audit. The NYSE would require all listed companies to have an internal audit function. Companies could outsource this task to an entity other than its independent auditor.

■ **BECAUSE EACH MEMBER OF AN AUDIT COMMITTEE** would have to be financially literate, and at least one committee member would need to have accounting or related financial management expertise, CPAs could showcase their knowledge and skills and contribute to an improved corporate culture by agreeing to serve on audit committees.

■ **COMPANIES LISTED ON THE NYSE** must continue to have

EXECUTIVE SUMMARY

■ **THE NEW YORK STOCK EXCHANGE HAS PROPOSED NEW** standards for its listed companies to compel audit committees to change their makeup, broaden their oversight of external auditors and assume greater responsibility for their fiduciary obligations. The audit committee would have the sole authority to retain and terminate the company's independent auditors and to approve an audit engagement's fees and terms.

■ **BECAUSE EACH MEMBER OF AN AUDIT COMMITTEE** would have to be financially literate, and at least one committee member would need to have accounting or related financial management expertise, CPAs could showcase their knowledge and skills and contribute to an improved corporate culture by agreeing to serve on audit committees.

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dependent, a company's board of directors must affirmatively determine he or she has no material relationship with the listed company either directly or as a partner, shareholder or officer of an organization that has a relationship with the company. Material relationships can include commercial, banking, accounting, legal, consulting, industrial, charitable and familial relationships. A board must disclose in the company's annual proxy statement how it determined a relationship was not material and may disclose the standards it used to judge independence. (The existing NYSE definition of independence precludes only any relationship with the listed company "that may interfere with the director's exercise of independence from management and the company.")

To satisfy the independence requirement, certain individuals would have to observe a stricter and broader "cooling-off" period before serving on a company's board in any capacity: five years for former employees of the listed company, employees of its present or former external auditor, former employees of any company whose compensation committee included an officer of the listed company and immediate family members in any of these categories. The existing cooling-off period is three years and applies only to former employees of the listed company.

Controlled companies (one in which an individual, a group or another company hold more than 50% of the voting power) would have to have a completely independent audit committee but would be exempt from the requirement that a board must have a majority of independent directors.

■ **Fees for audit committee members.** Directors' fees would be the only compensation audit committee members might receive from the company. Existing NYSE rules for audit committees have no such mandate. The increased responsibilities placed on audit committees would involve a significant time commitment; therefore the audit committee members could receive more compensation than other board directors. Audit committee members might receive their fees in cash or company stock, options or other consideration ordinarily available to directors. As long as an audit committee member satisfied the defini-



FEI's Philip Livingston thinks more attention should be paid to the skill levels of all members of an audit committee, not just the chairperson.

tion of independence, then receipt of a pension or other form of deferred compensation from the company for prior service would not preclude him or her from complying with the "directors' fees only" compensation requirement.

Examples of compensation audit committee members could not accept under the proposed standards include fees paid directly or indirectly for services as a consultant or legal or financial adviser and compensation paid to a director's business for consulting or advisory services even if he or she did not provide the actual service. However, disallowed compensation would not include ordinary compensation paid in other customer or supplier or business relationships that the board already had determined were not material for purposes of assessing a director's independence.

The proposed NYSE standards would require audit committees to fulfill their responsibilities by performing certain tasks. Each audit committee must

■ **Draft a written charter.** An audit committee must have a written charter that addresses the committee's purpose—that is, to assist board oversight with respect to the integrity of the company's financial statements, compliance with regulatory and legal requirements, the qualifications and independence of the external auditors and the performance of the company's internal and external audit functions. The



"It's important not to overwhelm the members of an audit committee with so many duties they can't do their job," says Dan M. Guy.

STEVE NORTH/BLACK STAR

audit committee may obtain input from management but cannot delegate to it these responsibilities. Thus the audit committee is directly responsible for the appointment, compensation and oversight of external auditors who in turn must report directly to that committee.

■ **Review the external auditor's report.** At least annually the audit committee must review the external auditor's report describing the company's internal control procedures, any issues arising from independent audits or regulatory investigations by governmental authorities and all relationships the audit firm has with the company. Also the audit committee must assure the rotation of the lead audit partner as required under federal law. To safeguard auditor independence, the committee also should consider the need for a regular rotation of the audit firm and report its findings to the full board of directors.

■ **Discuss annual and quarterly financial statements.** The audit committee must meet with management and the independent auditor to review audited annual and quarterly financial statements, including the company's disclosures under management's discussion and analysis (MD&A) of financial condition and operations. The committee may discuss earnings releases and earnings guidance in general, such as the type of presentation the company should make for quarterly earnings statements. It is not required to discuss in advance of publication each earnings release or each instance in which a company may provide earnings guidance to the public. (For more information about earnings releases, see "Hazy Reporting," *JofA*, Aug. 02, page 47.)

■ **Arrange meetings with management, internal auditors and independent auditors.** To

perform its oversight functions the audit committee must have separate sessions with management, those responsible for internal audit and external auditors. The NYSE rules would require all listed companies to have an internal audit function. This does not mean every company would have to establish a separate internal audit department. Companies might outsource this task as long as it's to an entity other than its independent auditor.

■ **Assess risk management.** While the CEO and senior management are responsible for their company's risk exposure, the audit committee must discuss with the internal and external auditors how the company handles major financial risks and the steps taken, within its guidelines and

policies, to monitor and control exposures to such risks. If a company has in place an oversight committee responsible for risk management, as well as other control mechanisms, then the audit committee should review these processes but need not substitute itself as the risk authority.

■ **Review any audit problems and management's response.** The audit committee must regularly review with the external auditor any difficulties encountered in the course of the audit, including any restrictions on the scope of the auditor's activities or access to requested information or any significant disagreement with management. Some items the audit committee may want to specifically review are accounting adjustments noted or proposed by the auditor but viewed as "immaterial" by management, communi-

cations between the auditor and the audit firm's national office regarding auditing or accounting issues that arose in the engagement and any "management" or "internal control" letter issued, or proposed to be issued, by the audit firm to the listed company.

■ **Promote sound hiring policies for audit firm employees.** While employees of audit firms can be valuable additions to a company's management, the audit committee should establish hiring policies governing such employment, taking into account the pressures for auditors seeking a position with the company they audit. (Audit committees should be aware of the following prohibition with respect to employment of former auditors in section 206 of the Sarbanes-Oxley Act of 2002: If a company's CEO, CFO, controller or chief accounting officer had been an employee of an audit firm and had worked on the company's audit, that firm may not provide audit services



Olivia F. Kirtley says future audit committees will have more people from the CPA profession. "CPAs and CFOs need to raise visibility," she says.

to the company for one year.)

According to a spokesperson for the NYSE, when the SEC approves the standards, the exchange plans to hire additional employees to monitor companies' compliance. (For information on implementation, see the timetable on page 57.) The sanctions the NYSE might impose on companies for failing to abide by these rules include issuing a public reprimand letter, suspending trading of the company's shares or delisting a company's stock from the exchange.

WANTED: A FEW GOOD MEN AND WOMEN

So what happens next? Audit committees can no longer be complacent—they face scrutiny and pressure from a

