



## **Understanding and Complying with the Sarbanes-Oxley and NYSE and Nasdaq Requirements Affecting Audit Committees**

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The Sarbanes-Oxley Act of 2002 (the “Act”) and the new corporate governance listing standards proposed by The New York Stock Exchange, Inc. (the “NYSE”) and the The Nasdaq Stock Market, Inc. (“Nasdaq”) will significantly affect the composition and expand the duties of the audit committees of boards of directors of public companies. Although many of the provisions that directly affect audit committees are not yet effective, the boards of directors of public companies should begin reexamining now the composition and role of their audit committees and their audit committee charters in order to be in a position to comply with the new requirements once they go into effect. Audit committees should also consider complying, as a best practice, with some of the new regulatory requirements even before they become effective.

This memorandum summarizes the provisions of the Act and the proposed NYSE and Nasdaq rules that will affect the composition, operation and charters of audit committees. Appendix A sets out, in greater detail, the timeframe in which specific requirements affecting audit committees will go into effect.

## A. The Sarbanes-Oxley Act.

The Act includes the following provisions that will affect the composition and duties of audit committees:

### 1. Requirements Applicable to Audit Committees of Listed Companies. (§301)

The Act directs the Securities and Exchange Commission (the “SEC”) to adopt, by April 26, 2003, rules to prohibit national securities exchanges and national securities associations from listing the securities of any company that does not have an audit committee that complies with the Act’s requirements. On January 8, 2003, the SEC issued proposed rules to implement this requirement. Under the Act and the proposed rules, the audit committee of a listed company must:

- (a) *Consist solely of “independent” directors.* A director will not qualify as “independent” under the Act if he or she
  - (1) accepts any consulting, advisory or other compensatory fee from the issuer (other than in his or her capacity as a director or member of a board committee);
    - Under the SEC’s proposed rules, both direct and “indirect” compensatory payments are prohibited. Indirect compensatory payments include:
      - payments to the audit committee member’s spouse, minor children or stepchildren, or children or stepchildren sharing a home with the audit committee member; or
      - payments to an entity in which the audit committee member is a partner, member or principal or has a similar position and which provides accounting, consulting, legal, investment banking, financial or other advisory services or any similar services to the company (but *not* payments made to such an entity in connection with an “ordinary course commercial business relationship”); or
  - (2) is an “affiliated person” of the issuer.
    - Under the SEC’s proposed rules, an affiliated person is defined as a person that directly or indirectly controls, or is controlled by, or is under common control with the company.
    - The SEC’s proposed rules provide that a person will *not* be deemed to be in control of a company if, among other things, such person does not beneficially own more than 10% of any class of equity securities of the company. The provision is intended as a safe harbor, and there is no presumption that a person who beneficially owns *more* than 10% of a class of equity securities is an affiliated person of the company.
    - Membership on the board of directors of a consolidated majority-owned subsidiary of a parent company will not, in and of itself, impair an audit committee member’s independence with respect to the parent company so long as the audit committee member receives only ordinary course compensation for his or her services as a director or board committee member of the subsidiary. Reliance on this exemption must, however, be disclosed in the company’s proxy statement, and that disclosure must be included or incorporated by reference in the company’s Form 10-K.

- (b) *Be directly responsible for the appointment, compensation and oversight of the company's independent auditors, including the resolution of disagreements between management and the auditor regarding financial reporting.* In the past, the audit committee charters of many public companies expressly excluded responsibility for resolving disputes between the independent auditors and management. That responsibility is now squarely placed on the audit committee, under both the Act and the SEC's proposed rules. In its instructions to its proposed rules, the SEC makes clear that the rules are not intended to prohibit a requirement, under a company's governing documents (or home-country law), that the shareholders elect or ratify the appointment of the company's auditors. If, however, the company recommends a particular auditor to the shareholders, that recommendation must come from the audit committee.
- (c) *Establish procedures to promote and protect "whistle blowing,"* including procedures for:
- receiving, retaining and addressing complaints received by the company relating to accounting, internal accounting controls, or auditing matters, and
  - enabling employees of the company to submit to the committee, on a confidential and anonymous basis, any concerns regarding questionable accounting or auditing matters.

The SEC expressly declined, in its proposed rules, to mandate specific procedures to be established by audit committees. However, the SEC is soliciting comment on whether it should mandate specific procedures, such as specifying the length of time for which complaints should be retained or imposing limitations on the persons who may or may not be designated to receive and handle complaints.

- (d) *Have the authority to engage its own independent counsel and other advisors, as the audit committee determines necessary to carry out its duties.* Both the Act and the proposed rules require the company to provide any funding needed, as determined by the audit committee, in connection with its engagement of the company's independent auditors or any advisors.

In its January 8, 2002 release, the SEC indicated that the audit committee requirements described above will apply only to companies with securities listed on a national securities exchange or through the automated inter-dealer quotation system of a national securities association. The SEC exempted non-equity securities issued by a consolidated, majority-owned subsidiary of a parent company, provided that the parent company is subject to the audit committee requirements.

Under the proposed rules, the SEC will require national securities exchanges or national securities associations to enforce compliance with the audit committee requirements by requiring listed companies to notify the exchange or association promptly after any executive officer becomes aware of any material failure by the listed company to comply with the rules. The SEC is soliciting comment on whether the notice requirements should also apply when any audit committee member becomes aware of any such material noncompliance. In issuing the proposed rules, the SEC assumes that listed companies will have an opportunity to correct any non-compliance with the rules, and that compliance will be enforced, under existing delisting procedures.

Although the Act requires the SEC's rules to be effective by April 26, 2003, the SEC intends to give national securities exchanges and national securities associations one year from the date of publication of the SEC's final rules to impose the rules' requirements on listed companies. The SEC acknowledged, in its proposing release, that certain self-regulatory organizations may impose, as listing standards, audit committee independence requirements which are more stringent than those reflected in the SEC's proposed rules.

## **2. Disclosure of Audit Committee "Financial Expert." (§407)**

On January 22, 2003, the SEC adopted rules requiring each public company to disclose in its Form 10-K (or in a proxy statement incorporated by reference in its Form 10-K) whether or not at least one member of its audit committee qualifies as an "audit committee financial expert" and, if not, why not. If the board of directors determines that at least one member of the audit committee qualifies as an "audit committee financial expert," the company must also disclose in its Form 10-K (or in a proxy statement incorporated by reference in its Form 10-K) the name of such person, whether or not he or she qualifies as "independent," and, if not, why not. The company may, but is not required to, disclose the names of additional members of the audit committee that it has determined qualify as "audit committee financial experts."

As defined in the SEC's rules, an "audit committee financial expert" is a person who

- (a) has the following attributes:
  - (1) an understanding of GAAP and financial statements;
  - (2) the ability to assess the general application of GAAP in connection with accounting for estimates, accruals and reserves;
  - (3) experience in preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues 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;
  - (4) an understanding of internal controls and procedures for financial reporting; and
  - (5) an understanding of audit committee functions; and
- (b) has obtained such attributes through:
  - (1) 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;
  - (2) experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;
  - (3) experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
  - (4) other relevant experience.

If the board determines that a person qualifies as an expert by virtue of "other relevant experience," the company's disclosure relating to its audit committee financial expert must briefly list that experience.

The rules adopted by the SEC also include a safe harbor from liability for audit committee financial experts. That safe harbor makes clear that:

- an "audit committee financial expert" is not an "expert" within the meaning of Section 11 under the Securities Act;
- an "audit committee financial expert" does not have, as a result of that designation, any duties, obligations or liability greater than those imposed on him or her as a member of the audit committee and the board; and
- the designation of a person as an "audit committee financial expert" does not affect the duties, obligations or liability of any other member of the audit committee or the board.

The disclosure rules relating to audit committee financial experts will apply to annual reports for fiscal years ending on or after July 15, 2003.

### **3. Audit and Non-Audit Services. (§§201 and 202)**

In conjunction with the establishment of a Public Company Accounting Oversight Board (the "Accounting Board"), the Act requires the SEC to adopt rules that will prohibit accounting firms from auditing the financial statements of public companies unless the accounting firm is registered with the Accounting Board. Under the Act, firms that are registered with the Accounting Board ("registered public accounting firms") will be prohibited from providing specified non-audit services to their audit clients and will be permitted to provide only those audit and permitted non-audit services that the company's audit committee has approved, in advance. On January 22, 2003, the SEC adopted final rules implementing its requirements relating to the provision of audit and non-audit services. These rules will apply to all engagements for audit and non-audit services entered into on or after May 6, 2003. Ongoing engagements for the provision of non-audit services that have been or are entered into before that date will not impair the auditor's independence, provided that such services are completed by May 5, 2004.

- (a) *Prohibited Non-Audit Services.* (§201(a)) Under the Act and the SEC's rules, it will be "unlawful" for a registered public accounting firm to provide any of the following non-audit services to an audit client "contemporaneously" with the audit:
- (1) bookkeeping services related to the audit client's accounting records or financial statements, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures;
  - (2) financial information systems design and implementation, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures;
  - (3) appraisal or valuation services, fairness opinions or contribution-in-kind reports, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures;
  - (4) actuarial services, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures;
  - (5) internal audit services, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures;
  - (6) management functions (defined to include acting, temporarily or permanently, as an officer, director or employee of the audit client or performing any decision-making, supervisory or on-going monitoring role);
  - (7) human resources services;
  - (8) broker-dealer, investment adviser or investment banking services;
  - (9) legal services (defined to include services that "could be provided only by someone licensed, admitted or otherwise qualified to practice law in the jurisdiction in which the service is provided"); and
  - (10) expert services unrelated to the audit (defined to include providing expert opinions or services in connection with litigation or administrative or regulatory proceedings or acting as an advocate for the audit client in such proceedings, but not including providing factual testimony relating to work performed or explanations of the positions taken or the conclusions reached during the performance of any service for the audit client).

The SEC's previous auditor independence rules, as adopted in November 2000, precluded an auditor from providing the kinds of services listed above under Items (1) through (9). Those prohibitions were subject, however, to a number of material exceptions for specified services that have been eliminated under the new rules. In lieu of the old exceptions, the new rules provide an exception, in the case of services of the types listed in items (1) through (5), if it is reasonable to conclude that the results of those services will not be subject to audit procedures in connection with the audit of the company's financial statements.

According to the adopting release, the list of prohibited services is predicated on three basic principles. A public company auditor, in order to be independent, cannot:

- function in the role of management;
- audit his or her own work; or
- serve in an advocacy role for his or her client.

In its December 2, 2002 release proposing rules under Sections 201 and 202 of the Act, the SEC stated that a non-audit service (most notably, a tax service) that violates one or more of these principles impairs an auditor's independence, whether or not such a service is expressly prohibited by the rules. The final rules represent somewhat of a retreat from this position. Instead, the SEC flatly stated that an accounting firm can provide tax services (expressly including tax compliance and tax planning services and tax advice) to its audit clients without impairing its independence. The SEC cautioned, however, that merely labeling a service a "tax service" would not be sufficient if the service involved "representing an audit client before a tax court, district court or federal court of claims" (which would constitute prohibited "expert services" under rules). The SEC also stated that audit committees should "scrutinize carefully the retention of an accountant in a transaction initially recommended by the accountant, the sole business purpose of which may be tax avoidance and the tax treatment of which may not be supported in the Internal Revenue Code and related regulations."

- (b) *Pre-approval of Audit and Permitted Non-Audit Services.* (§202) Under the Act, the audit committee will also be required to approve, in advance:
- all audit, review and attest services (which may entail providing comfort letters in connection with securities underwritings), and
  - all non-prohibited non-audit services to be provided by the company's auditors, *including tax services*, subject to a *de minimis* exception described below.

Under the *de minimis* exception, the audit committee will not be required to pre-approve *non-audit* services of a kind permitted by the Act that account, in the aggregate, for less than 5% of the total revenues paid by the company to its auditors during the fiscal year in which such services are provided, if (1) the company did not recognize such services as "non-audit" services at the time of the engagement and (2) such services are promptly brought to the attention of, and approved by, the audit committee before the completion of the audit. Under the Act, the audit committee is permitted to delegate to one or more of its members the authority to pre-approve audit or non-audit services (or to approve, after the fact, non-audit services that fall within the *de minimis* exception) so long as any decisions made under delegated authority are presented to the full audit committee at its next scheduled meeting.

All engagements "in connection with audit, review and attest reports required under the securities laws" must be approved by the audit committee in advance. Subject to the *de minimis* exception described above, permitted non-audit services may either (1) be approved in advance by the audit committee or (2) be entered into pursuant to preapproval policies and procedures established by the audit committee, provided that (a) the policies and procedures are detailed as to the particular service, (b) the audit committee is informed of each such service, and (c) such policies and procedures do not include delegation of the audit committee's responsibilities to management. The Act would appear to require that, if such policies include the delegation of pre-approval authority to any person, it be to one or more members of the audit committee.

- (c) *Disclosure of Approval of Non-Audit Services.* (§202) The SEC's rules also require companies to disclose in their proxy statements
- any policies and procedures developed by the audit committee concerning the pre-approval of the provision of both audit and nonaudit services and
  - the amount paid to the company's independent auditor, in each of its two most recent fiscal years, as
    - audit fees,
    - audit-related fees (defined as fees for "assurance and related services" reasonably related to the audit),
    - tax fees (including fees for tax compliance, tax consulting and tax planning services), and
    - all other fees.

Companies must also disclose the relative percentages of fees in each category that were approved by the audit committee in accordance with the procedures described above.

#### 4. Obligations of Other Persons to Report to the Audit Committee.

The Act also imposes on the independent auditors and management the obligation to report certain matters to the audit committee (thus effectively imposing upon the committee an obligation to address those matters), including the following:

- (a) *Independent Auditors.* (§204) Under the Act and the SEC's rules, registered public accounting firms will be required to report directly to the audit committee, before the company files its audit report with the SEC:
- all critical accounting policies and practices to be used,
  - all alternative treatments of financial information within GAAP that have been discussed with management, the ramifications of such alternative disclosures and treatments, and the accounting treatment "preferred" by the registered public accounting firm, and

- any other material written communications with management, such as a management letter, report of the auditor's observations and recommendations on internal controls, and any schedule of material adjustments and reclassifications that were proposed and a listing of any that were not recorded.

Such communications are not required to be in writing (although the SEC has indicated that it would expect both the company and the auditor to document the occurrence of the communication). These requirements take effect May 6, 2003.

- (b) *Management. (§302)* As required by the Act, effective August 29, 2002, the SEC adopted rules imposing upon the company's CEO and CFO an ongoing obligation to certify, in each annual and quarterly report, that they have reviewed the report and the report does not contain any material misstatements or omissions. The CEO and CFO must also certify, among other things, that they are responsible for, and have evaluated the adequacy of, the company's disclosure controls and procedures and that they have disclosed to the company's independent auditors *and audit committee*:

- all significant deficiencies in the design or operation of the company's internal controls which could adversely affect the company's ability to record, process and report financial data, and
- any fraud (whether or not material) involving management or other employees who have a significant role in the company's internal controls.

This certification is in addition to, and not in lieu of, the certification under Section 906 of the Act (which was effective immediately upon the enactment of the Act).

## 5. Other Provisions of Interest to Audit Committees.

The following provisions of the Act and related rules, among others, are relevant to audit committees in connection with their oversight obligations:

- *Expanded Scope of Audit Report. (§404)* The SEC is required to adopt rules requiring each annual report under the 1934 Act to include an internal control report stating management's responsibility for establishing and maintaining adequate internal financial reporting controls and containing an assessment of the effectiveness of those controls as of the end of the fiscal year covered in the report, as attested to, and reported on, by the "registered public accounting firm" that issued the company's audit report. On October 22, 2002, the SEC published for comment proposed rules that would require public companies to include in their annual reports such a statement by management, together with the auditors' attestation report. The SEC has not yet issued final rules and has indicated that it expects the final rules to apply to annual reports for fiscal years ending on or after September 15, 2003.
- *Mandatory Rotation of Audit Partners. (§§203 and 207)* Under the Act, registered public accounting firms will be required to rotate the lead audit partner and the review partner on each public company account so that neither performs audit services for an account for which he or she performed audit services in each of the five previous fiscal years. The rules adopted by the SEC on January 22, 2003 reiterate this requirement and further provide that the lead audit partner and the review partner, once rotated off of the assignment, may not be reassigned to the audit client for a period of five years. The SEC also extended the rotation requirements to other "audit partners," defined in the rules to include, among others, audit engagement team partners who provide more than ten hours of audit, review or attest services in connection with the annual or interim financial statements of the audit client. Such partners are required to rotate off of an assignment after seven years and may not be reassigned to the audit client for a period of two years. The Act also requires the Comptroller General to complete a study, by July 30, 2003, of the potential effects of requiring mandatory rotation of auditing firms.
- *Auditor Conflicts of Interest. (§206)* Under the Act and the final rules adopted by the SEC on January 22, 2003, registered public accounting firms will be prohibited from auditing a company's financial statements if the company's CEO, CFO, controller, chief accounting officer or any other person serving in a "financial reporting oversight role" was employed by the registered public accounting firm and participated in an audit of the company during the immediately preceding audit engagement period. The audit engagement period for

any fiscal year is deemed to have begun on the day after the Form 10-K for the preceding fiscal year was filed and to end on the day on which the Form 10-K for that fiscal year is filed.

- *Prohibition against Improper Influence on an Audit. (§303)* The SEC is required to approve, by April 26, 2003, final rules making it unlawful for any officer or director of a public company, or any other person acting under his or her direction, to take any action to fraudulently influence, coerce, manipulate or mislead any independent public or certified accountant engaged in an audit of the company's financial statements for the purpose of rendering those financial statements materially misleading. On October 18, 2002, the SEC published for comment proposed rules implementing this requirement. The proposed rules basically track the language in the Act but provide that the prohibition applies to any action that the officer or director (or person acting under his or her direction) "knew or was unreasonable in not knowing ... could, if successful, result in rendering the financial statements materially misleading." The proposed rules specify types of actions that could, if successful, have such a result, including, for example, fraudulently influencing an auditor (1) to issue a report not warranted by the circumstances, (2) not to perform an audit or review required by generally accepted auditing standards, or (3) not to communicate matters to the company's audit committee.
- *Financial Statement Disclosures. (§401)* Under the Act, financial statements included in 1934 Act reports are required to reflect "all material correcting adjustments that have been identified by a registered public accounting firm" in accordance with GAAP and the rules and regulations of the SEC. The Act required the SEC to issue final rules (1) requiring financial statements included in annual and quarterly reports filed with the SEC to disclose all material off-balance sheet transactions between the company and unconsolidated entities or other persons (adopted on January 22, 2003), and (2) regulating the presentation and use of pro forma financial information in reports filed with the SEC, press releases or other public disclosures (adopted on January 15, 2003). The Act also requires the SEC to conduct a study and prepare a report on public company use, and the transparency of the reporting, of off-balance sheet transactions, including the use of special purpose entities.
- *Required Adoption of a Code of Ethics for Senior Financial Officers. (§406)* The Act required the SEC to adopt rules requiring each public company to disclose whether or not it has adopted a code of ethics for its senior financial officers and, if not, why not, and to make immediate public disclosure of any change in or waiver of the code. The rules adopted by the SEC on January 15, 2003 extend the code of ethics requirement to a public company's principal executive officer, principal financial officer, principal accounting officer or controller, and persons performing similar functions. The rules also define a "code of ethics" as a codification of standards reasonably designed "to deter wrongdoing" and to promote:
  - (1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
  - (2) full, fair, accurate, timely and understandable disclosure in SEC reports and other public disclosure;
  - (3) compliance with applicable laws and regulations;
  - (4) the prompt internal reporting of violations of the code to appropriate persons specified in the code; and
  - (5) accountability for adherence to the code.

The company is required either to (1) file a copy of the code as an exhibit to its Form 10-K, (2) post the text of the code on its website or (3) include an undertaking in its Form 10-K to provide a copy of its code to any person, without charge, upon request. The instructions to the final rules make clear that the code of ethics for senior financial officers may be a separate code or part of a broader code of ethics that addresses additional topics and applies to persons other than the officers specified in the rules. If the code of ethics for senior financial officers is part of a broader code, the company need only file, post or provide those portions of the code that are required under the rules and that apply to senior financial officers, as defined in the rules.

Companies must comply with the disclosure requirements relating to the code of ethics for senior financial officers in their annual reports for fiscal years ending on or after July 15, 2003.

## B. Proposed NYSE Rules Affecting Audit Committees.

The NYSE filed its proposed new corporate governance rules with the SEC on August 16, 2002 and, on March 12, 2003, filed a proposed rule change excerpting, amending and restating the provisions with respect to director independence. The NYSE's proposed rules will not become effective until they have been approved by the SEC, following a public notice and comment period. With one exception, the SEC has not yet published the rules for comment. The NYSE has indicated informally that it expects the proposed rules to be published sometime this spring and to become effective in 2004. The proposed rules contemplate a longer phase-in period for compliance with the requirements relating to director independence.

The proposed new NYSE listing requirements affecting the composition and duties of audit committees include those described below. Note that the corporate governance rules proposed by the NYSE include both mandatory and recommended standards of practice for listed companies. As the NYSE explains in its rule filing, the word "must," when used in the rules, indicates a standard or practice with which listed companies are required to comply. Use of the word "should," on the other hand, indicates a standard or practice that the NYSE "believes is appropriate for most if not all companies." Failure to comply with such standard, however, will not constitute a listing violation. [Initial NYSE Rule Filing, Footnote 2]

### 1. Enhanced Independence Requirements for Audit Committee Members. (§303A.2 and §303A.6)

The NYSE proposes to tighten its existing definition of "independent director" and impose additional independence requirements on directors who serve on the audit committees of NYSE-listed companies. Under the NYSE's proposed rules, a board of directors must affirmatively determine that a director has no material relationship with the company (either directly or as a partner, shareholder or officer of an organization that has such a relationship) before the director will qualify as independent. Moreover, the company must disclose these determinations in its proxy statement. The board may adopt categorical standards to assist it in determining independence (for example, quantifying what it considers to be a "material" relationship), provided that the board discloses those standards and explains any determination of independence for a director who does not meet the standards. The March 2003 proposed rule change makes it clear that the concern is independence from management, and that ownership of a significant amount of stock is not, by itself, a bar to a finding of independence.

The proposed rules create a rebuttable presumption that a director who receives, or whose immediate family member receives, more than \$100,000 per year in direct compensation from the listed company, other than director and committee fees and pension or deferred compensation for prior service, is *not* independent until five years after such director (or such director's immediate family member) ceases to receive more than \$100,000 per year in such compensation. While the board may negate this presumption and find the director to be independent, it must explain its decision in the company's proxy statement and must specifically address the relevant facts and circumstances, without relying on any categorical standards.

The proposed rules also identify three categories of relationships between a listed company and a director (or his or her immediate family member) that will preclude a finding that that director is independent. Under these provisions, the following directors are not "independent":

- a director of the listed company who is affiliated with or employed by, or whose immediate family member is affiliated with or employed in a professional capacity by, the company's present or former auditors,
- a director of the listed company who is employed, or whose immediate family member is employed, as an executive officer of another company on whose compensation committee any executive officer of the listed company sits; or
- a director of the listed company who is an executive officer or an employee, or whose immediate family member is an executive officer, of another company where one of those companies accounts for at least 2% or \$1 million, whichever is greater, of the other company's consolidated gross revenues.

Under the general rule, directors described in these three categories will remain nonindependent until five years after the end of the affiliation or relationship causing them to be non-independent, or until five years after one company ceases to account for more than 2% or \$1 million of the revenues of the other. However, for the first five years after the effective date of the new rules, the "look back" period will be shortened to the period since that effective date.

Additional requirements would apply to directors who serve on audit committees. More specifically, a director may not be deemed “independent” for purposes of service on an audit committee if the director received from the company any compensation, without regard to materiality, in the current or previous fiscal year other than (1) directors’ fees or (2) in the case of a former employee who otherwise qualifies as independent, a pension or other deferred compensation for prior service. Compensation paid to a director’s firm for consulting or advisory services will disqualify a director from serving on an audit committee even if the director is not the actual service provider. Directors’ fees are defined to include equity-based awards and fees for chairing or serving on board committees.

The NYSE has indicated that it expects to give listed companies 18 months from the date that the SEC approves its new listing standards to comply with the enhanced qualification requirements for audit committee members, and an additional year for companies with classified boards. Notwithstanding any such phase-in provisions, the independence requirements imposed under Section 301 of the Act will become effective in accordance with the Act. See Section A.1, above.

## **2. Limitations on the Number of Audit Committees on Which a Director May Serve. (Commentary to §303A.6)**

Under the NYSE’s proposed rules, a NYSE-listed company must either (a) limit to three the aggregate number of audit committees on which its audit committee members may serve or (b) determine, on a case-by-case basis, that simultaneous service on more than three audit committees will not impair the ability of the director to serve effectively on the company’s audit committee and disclose that determination in its annual proxy statement. It is not clear when this requirement would go into effect.

## **3. Sole Responsibility for Audit Engagement. (§303A.7(a))**

Under the NYSE’s proposed rules, the audit committee must have the sole authority to hire and fire independent auditors and to approve any significant non-audit relationship with the independent auditors. The NYSE proposes to make this requirement effective six months after the date that the SEC approves the new listing standards.

## **4. Requirement and Content of a Written Charter. (§303A.7(b))**

Under the NYSE’s proposed rules, each audit committee of an NYSE-listed company also would be required to have, within six months after the date that the SEC approves the new listing standards, a written charter that addresses:

- (a) The audit committee’s purpose — which, at a minimum, must be to:
  - (1) Assist the board in its oversight of
    - the integrity of the company’s financial statements;
    - the company’s compliance with legal and regulatory requirements;
    - the independent auditor’s qualifications and independence; and
    - the performance of the company’s internal audit function and independent auditors; and
  - (2) Prepare the report required, under the SEC’s rules, to be included in the company’s annual proxy statement; and
- (b) The audit committee’s duties and responsibilities, which, at a minimum, must be to:
  - (1) Retain and terminate the company’s independent auditors (subject, if applicable, to shareholder ratification). According to the NYSE Commentary, the audit committee may obtain management’s input in fulfilling this obligation, but may not delegate this responsibility to management.
  - (2) Obtain and review, at least annually, a report by the independent auditors describing (A) the auditor’s internal quality control procedures, (B) any material issues raised by its most recent internal quality-control review, or peer review, of the firm or by any inquiry or investigation by governmental or professional authorities in the preceding five years relating to an independent audit conducted by the firm and any steps taken to deal with such issues, and (C) all relationships between the independent auditor and the company. According to the NYSE, this information is intended to permit the audit committee to conduct an annual review of the qualifications, performance and independence of the

auditor and its lead partner. In conducting that review, the audit committee should take into account the opinions of management and the internal auditors. In addition to assuring that the audit partner is rotated every five years, as required under the Act, the audit committee should consider whether there should be a regular rotation of the audit firm in order to assure continued independence. The audit committee should report its conclusions to the board.

- (3) Discuss the annual audited and quarterly financial statements with management and the independent auditors, including the disclosures under MD&A. The audit committee *must* review:
  - major issues regarding accounting principles and financial statement presentations, including any significant changes in the company's selection or application of accounting principles and major issues as to the adequacy of its internal controls and any special audit steps taken in light of major control deficiencies;
  - analyses prepared by management and/or the independent auditor setting forth significant financial reporting issues and judgments made in connection with the preparation of the financial statements, including an analysis of the effects of alternative GAAP methods on the financial statements; and
  - the effect of regulatory and accounting initiatives, as well as off-balance sheet structures, on the financial statements.
- (4) Discuss earnings press releases and financial information and earnings guidance provided to analysts and rating agencies. In discussing earnings press releases, the audit committee *must* pay particular attention to the use of "pro forma" or "adjusted" non-GAAP information. The NYSE Commentary makes clear that the audit committee need not discuss in advance each earnings release or instance of earnings guidance but may discharge this duty by discussing more generally the types of information to be disclosed and the kind of presentation to be made.
- (5) Have the power to retain legal, accounting or other advisors without board approval.
- (6) Discuss the company's risk assessment and risk management policies. According to the NYSE Commentary, although management is, and other bodies may also be, responsible for risk assessment and management, the audit committee must discuss the guidelines and policies governing that process. The audit committee should discuss the company's major financial risk exposures and the steps management has taken to monitor and control such risk.
- (7) Meet separately, periodically, with (A) management, (B) the internal auditors and (C) the independent auditors.
- (8) Review with the independent auditors any audit problems or difficulties and management's response. According to the NYSE Commentary, such a review must include any restrictions on the scope of the independent auditors' activities or their access to information and any significant disagreements with management. The audit committee may also want to review (A) any accounting adjustments that were noted by the independent auditor but "passed" (as immaterial or otherwise), (B) any communications between the audit team and the audit firm's national office about auditing or accounting issues raised in the engagement, or (C) any management or internal control letter issued, or proposed to be issued, by the audit firm to the company. The review should also include a review of the responsibilities, budget and staffing of the company's internal audit function.
- (9) Set clear hiring policies for employees or former employees of the independent auditors (taking into account the pressures that may exist for auditors who may be consciously or unconsciously seeking a job with the company).

(10) Report regularly to the board of directors. According to the NYSE Commentary, the report should include a review of any issues relating to the quality or integrity of the company's financial statements, the company's compliance with legal or regulatory requirements, the performance or independence of its independent auditors, or the performance of the internal audit function.

(c) The requirement that the audit committee conduct an annual evaluation of its own performance.

#### 5. Requirement of an Internal Audit Function. (§303A.7(c))

Listed companies are also required to have in place an appropriate control process for reviewing and approving internal transactions and accounting. Listed companies may outsource this function to a firm other than its independent auditor.

### C. Proposed Nasdaq Rules Affecting Audit Committees.

Nasdaq filed its proposed new rules with the SEC on October 9, 2002 and, on March 11, 2003, filed a proposed rule change amending and restating its proposal. Nasdaq's proposed rules will not become effective until they have been approved by the SEC, following a public notice and comment period, and the SEC has not yet published the rules for comment. Nasdaq's proposal contemplates that the proposed rule changes that affect board or audit committee compensation must be complied with no later than a company's first annual meeting after January 1, 2004, and the other changes would become effective six months after SEC approval. Proposed Nasdaq rules affecting the composition and duties of audit committees include the following:

#### 1. Changes to the Definition of "Independent" Director.

Under Nasdaq's current rule, a director will not qualify as independent, and thus generally cannot serve as a member of the audit committee, if he or she (1) has been employed by the listed company or its affiliate within the last three years, (2) received more than \$60,000 in compensation (excluding compensation for board service or under certain retirement plans) from the listed company and its affiliates in the previous fiscal year (Nasdaq has interpreted this to include payments in the current fiscal year), (3) has a family member who was employed as an executive officer of the listed company or its affiliate, (4) is a partner, controlling shareholder or executive officer of a "for profit" business to which the listed company made, or from which the listed company received, payments exceeding the greater of 5% of the recipients consolidated gross revenues or \$200,000 or (5) is employed by another company having a compensation committee interlock with the listed company. The proposed changes would

- expand the prohibition in clause (2) to provide that a director will not be considered independent if the director *or any of his or her family members* has received *any* payments (not limited to "compensation," but excluding compensation for board service or under certain retirement plans, as well as payments in respect of the company's securities and compensation received by family members who are employees, provided they are not executive employees) in excess of \$60,000 in the current year *or the preceding three years*,
- extend the prohibition in clause (3) to cover *any* (not just a "for profit") organization with which the director has the specified relationship, and
- add a new clause providing that a director will not be considered independent if he or she is a former partner or employee of the company's outside auditors who worked on the company's audit engagement in the preceding three years.

The commentary to the proposed rule notes that Nasdaq does not believe that ownership of company stock should, by itself, preclude a finding of independence. However, stock ownership may be an issue under the additional, more stringent requirements that apply to audit committees.

In connection with these changes, Nasdaq proposes to add a definition of "Family Member," which is defined broadly to include any person who is a relative by blood, marriage or adoption or who shares the same residence.

## 2. Enhanced Qualifications for Audit Committee Members.

Under Nasdaq's proposed rules, audit committee members would be required

- to be independent directors under the applicable Nasdaq rules,
- to meet the criteria for independence in Section 10A(m)(3) of the Securities Exchange Act of 1934 (§301 of the Act) (see A.1(a) above),
- not own or control 20% or more of the company's voting securities (or such lower measurement as the SEC may determine through rulemaking) and
- to meet Nasdaq's "financial literacy" standards, which would generally remain unchanged, except for the deletion of the provision affording a new committee member "a reasonable period of time" to become financially literate.

Thus, for example, a director who received a payment of \$10,000 from the company in the current year, other than for board or committee service, might be deemed independent under Nasdaq's rules, but could not serve on the audit committee. A director who received *no* payments in the current year might still be precluded from serving on the audit committee if he or she failed to meet Nasdaq's independence requirements (e.g., if he or she received payments in excess of \$60,000 in any of the preceding three years.)

Nasdaq would continue to permit a director who does not comply with Nasdaq's independence requirements to serve on an audit committee if

- the committee has at least three members
- the director
  - meets the independence requirements for audit committee members under the Act,
  - does not own or control 20% or more of the company's voting securities and
  - is not, and does not have a family member who is, an officer or employee of the company;
- the board, under "exceptional and limited circumstances," determines that the director's service on the audit committee is required by the best interest of the company; and
- the board discloses in the company's next annual proxy statement the nature of the relationship that prevents the director from meeting Nasdaq's independence requirements and the reasons for the board's determination.

Only one member of the audit committee may be appointed under this exception, and any such member would be prohibited from serving for more than two years or as chair of the audit committee.

Nasdaq also proposes to eliminate its existing exceptions from the audit committee requirements for small business issuers.

## 3. Enhanced Duties and Obligations.

Nasdaq's proposed rules regarding audit committee charters would require an audit committee to:

- approve, in advance, all audit services and permissible non-audit services by the auditor, as required under the Act,
- have the sole authority to appoint, determine the funding for, and oversee the outside auditors, as required under the Act
- establish procedures for the treatment of complaints received by the company, as required under the Act, and
- have the authority to engage and determine the funding for independent counsel and other advisors, as required under the Act.

#### **4. Requirement to Disclose Audit Opinions with Going Concern Qualifications.**

Nasdaq also proposes to require listed companies to issue a press release if the audit report expresses substantial concern about the company's ability to continue as a going concern for a reasonable period of time.

## Appendix A — Timetable for Implementation of Provisions of Sarbanes-Oxley Act and NYSE Rules Affecting Audit Committees

### 2002

July 30	Sarbanes-Oxley Act is enacted
August 29	SEC adopts final rules requiring CEO/CFO certification of quarterly and annual reports (with the related obligation to disclose to the audit committee any problems with internal controls) (§302).
October 18	SEC issues proposed rules implementing prohibition against improper influence on audits; comment period expired November 25, 2002; final rules required to be adopted by April 26, 2003 (§303).
October 22	SEC issues proposed rules relating to the requirement that public companies include in their annual reports a report on the effectiveness of the company's internal controls; comment period expired November 29, 2002; no fixed date for required adoption of final rules (but see entry for September 15, 2003).

### 2003

January 8	SEC issues proposed rules requiring national securities exchanges and national securities associations to require listed companies to have audit committees that comply with the independence standards and that have the duties and responsibilities (including sole responsibility for the engagement of the independent auditors) specified in the Sarbanes-Oxley Act; comment period open until February 18, 2003; final rules required to be adopted by April 26, 2003 (§301).
January 15	SEC approves final rules: <ul style="list-style-type: none"><li>• Defining “audit committee financial expert” and implementing the related disclosure requirements (Adopting Release dated January 22, 2003) (§407);</li><li>• Implementing the requirement that public companies adopt codes of ethics for their senior financial officers (Adopting Release dated January 22, 2003) (§406).</li><li>• Governing the presentation of pro forma financial information in periodic or other reports filed with the SEC or in press releases or other public disclosure documents (Adopting Release dated January 22, 2003) (§401(b)).</li></ul>
January 22	SEC approves final rules: <ul style="list-style-type: none"><li>• Prohibiting “registered public accounting firms” from providing certain non-audit services concurrently with an audit; (Adopting Release dated January 28, 2003) (§§201 and 208).</li><li>• Requiring audit committees to pre-approve audit and non-audit services by the auditor of the issuer (Adopting Release dated January 28, 2003) (§§202 and 208).</li></ul>

- Requiring audit partner rotation by registered public accounting firms (Adopting Release dated January 28, 2003) (§§203 and 208).
- Requiring registered public accounting firms to report, on a timely basis, critical accounting policies and other matters to the audit committee (Adopting Release dated January 28, 2003)(§§204 and 208).
- Making it unlawful for a “registered public accounting firm” to audit an issuer if certain specified senior officers of the issuer were employed by the firm in the preceding year and participated in the audit (Adopting Release dated January 28, 2003) (§§206 and 208).
- Providing that annual and quarterly financial statements filed with the SEC disclose material off-balance sheet transactions between the issuer and unconsolidated entities or other persons (Adopting Release dated January 27, 2003) (§401(a)).

March 28

Rules governing presentation of pro forma financial information apply to reports filed with the SEC with respect to fiscal years ending after this date.

By April 26

By April 26 Under the Sarbanes-Oxley Act, the SEC is required to complete the following:

- determine that the Public Company Accounting Oversight Board (the “Accounting Board”) is operational (§101(d)).
- issue final rules:
- Requiring national securities exchanges and national securities associations to require listed companies to have audit committees that comply with the independence standards and that have the duties and responsibilities; proposed rules were issued on January 8, 2003 (§301); and
- Making it unlawful for any officer or director or person acting at their direction improperly to influence an audit; proposed rules were issued on October 18, 2002 (§303).

May 6

The following rules on auditor independence approved by the SEC on January 22, 2003 take effect:

- All *new* audit and non-audit engagements must be pre-approved by the audit committee and must comply with the requirements of the SEC’s new auditor independence rules.
- Auditors must discuss with the audit committee critical accounting policies and other specified matters prior to the filing of an audit report with the SEC.
- The revised rules governing proxy statement disclosure of fees for audit, non-audit and tax services go into effect.
- Rules requiring one-year cooling-off period for employment relationships with former participants in the company’s audit engagement team go into effect (but relationships entered into prior to this date are grandfathered under the rules).

June 15	Companies must comply with new disclosure requirements for off-balance sheet transactions in financial statements filed with the SEC for fiscal years ending after this date.
July 15	Companies must comply with disclosure requirements relating to “audit committee financial experts” and the code of ethics for senior financial officers in annual reports for fiscal years ended after this date (subject to certain relief from these requirements for small business issuers).
By July 30	The Comptroller General must complete its study of the potential effects of mandatory rotation of audit firms (§207).
September 15	Under the SEC’s October 18, 2002 proposing release, the new auditor attestation standards relating to internal control reports would apply to audit reports filed in connection with financial statements for fiscal years ending on or after this date.
By October 23 (or 180 days after the Accounting Board is deemed operational, if earlier)	All public accounting firms must be registered with the Accounting Board. (§102)
December 15	Companies must comply with the new disclosure requirement to include a table of contractual obligations in financial statements filed with the SEC for fiscal years ending after this date.

## **2004**

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January 1	For companies with fiscal years corresponding to the calendar year, the failure of the lead and reviewing partner of the company’s auditor to comply with the auditor rotation rules on or after this date will result in impairment of the auditors’ independence. (The rules become effective on the first day of the issuer’s fiscal year following the 90th day after the auditor independence rules are published in the <i>Federal Register</i> ). Service on the audit engagement team prior to this date is counted for the lead and reviewing partner but not for other “audit partners” in determining whether or not independence is impaired.
By January 26	The SEC must complete a study of the extent of public company use of off-balance sheet transactions, including the use of special purpose entities, and the transparency of the treatment of those transactions under GAAP (§401(c)(1))
Late January (270 days after publication in the Federal Register of the SEC’s final rules requiring national securities exchanges and national securities associations to impose specified independence and other requirements on audit committees, due April 26, 2003)	Date by which NYSE, Nasdaq and other national securities exchanges will be required to have in place final rules implementing the audit committee independence and other requirements imposed on audit committees under Section 301 of the Sarbanes-Oxley Act.

Late April  
(first anniversary of publication  
date of the SEC's final rules  
requiring national securities  
exchanges and national  
securities associations to  
impose specified independence  
and other requirements on audit  
committees)

Date by which final rules adopted by the NYSE, Nasdaq and other national securities exchanges implementing the audit committee independence and other requirements imposed on audit committees under Section 301 of the Sarbanes-Oxley Act are required to be operational.

May 6

Last date on which auditing firms can continue providing non-audit services that commenced prior to the effective date of the new auditor independence rules and were not pre-approved by the audit committee.

By July 26

The SEC must submit a report on public company use of off-balance sheet transactions, including the use of special purpose entities, together with the SEC's recommendations for improving the transparency and quality of the reporting of those transactions, to the President and Congressional committees (§401(c)(2)).

## For Further Information

This memorandum has been prepared for the general information of readers. It is not meant to provide legal advice with respect to any specific matter.

For more information regarding the impact of the Sarbanes-Oxley Act and the proposed NYSE and Nasdaq rules on audit committees, please contact any of the following attorneys or any other member of the firm's Corporate & Securities Practice Group.

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