VEDDER PRICE

Corporate Securities

A bulletin designed to keep corporate executive and investment banking professionals informed on major developments in the securities industry

If you have questions regarding material in this issue of *Corporate Securities* or suggestions for a specific topic you would like addressed in a future issue, please contact Steven J. Gray (312/609-7528), Jennifer R. Evans (312/609-7686), Dan L. Goldwasser at 212/407-7710, or any other Vedder Price attorney with whom you have worked.

November, 1999

Addressing the Blue Ribbon Committee's Recommendations

The accounting profession has long contended that management must take responsibility for its own financial statements and that reliable financial reporting requires the active involvement of board members. Accordingly, the accounting profession, the SEC, the NASD, the NYSE and others have encouraged companies to form and empower audit committees to oversee accounting and reporting functions. While most large public companies, with the encouragement of stock exchange listing requirements, have complied with this recommendation, the duties and responsibilities of audit committees have never been delineated, with the result that the role of the audit committee varies greatly from company to company. Moreover, recent studies have revealed that most audit committees, particularly those of small public companies, are largely ineffective.

In order to remedy this situation and improve financial reporting, Arthur Levitt, Jr., Chairman of the SEC, called for a "Blue Ribbon" committee to review the role of audit committees and to make recommendations for improving their effectiveness. (See *Corporate Securities*, March 1999). Following this suggestion, the NYSE and the NASD sponsored an 11-member panel chaired by John C. Whitehead, a former Deputy Secretary of State and retired Co-Chairman of Goldman Sachs & Co, and Ira M. Milstein, a senior partner of Weil, Gotshal & Manges LLP. Also included on the Blue Ribbon Committee were the CEOs of the NYSE and the NASD, two CEOs of Big Five Accounting firms, a former Comptroller General of the U.S. and four senior executives of public companies. After holding hearings, the Blue Ribbon Committee in February l999 issued its report in which it made ten suggestions for enhancing the performance of audit committees. These recommendations included the following:

- Stock exchanges should adopt rules requiring public companies whose shares are listed for trading to have an audit committee composed of at least three directors, all of whom must be financially literate and independent, and at least one of whom should have accounting or related financial management experience.

- Each audit committee should adopt a written charter governing its operations, and the SEC should adopt rules requiring annual disclosure of the terms of and compliance with the charter.

- The SEC should require all reporting companies to include in their annual reports on Form 10-K certain representations of the audit committee, including a statement that the audit committee believes that the company's financial statements "are fairly presented in conformity with generally accepted accounting principles (GAAP) in all material respects."

- The SEC should adopt safe harbor rules relating to the foregoing disclosures.

- The SEC should require public companies to engage their auditors to conduct "a SAS 71 (Interim Financial Review)" of quarterly financial reports before they are filed with the SEC.

These measures will certainly cause a higher level of oversight of the financial reporting of public companies and may provide substantial safeguards against erroneous financial reports; however, they will do so at the cost of substantially higher liability exposures for audit committee members unless a comprehensive safe harbor is also adopted. Moreover, it is questionable whether the SEC, in the absence of enabling legislation, has the power to adopt such exemptions from liability. In addition, a requirement for audit committee members to report on the compliance with GAAP would violate the laws of most states which require CPA licensure in order to make such statements. Accordingly, the recommendations of the Blue Ribbon Committee contain a certain amount of "wishful thinking."

This article explores what public companies can and should do as interim measures prior to the adoption of the Blue Ribbon Committee's recommendations by the stock exchanges and the SEC.

Voluntary Actions

It should be noted at the outset that Connecticut is the only state that has enacted a statutory requirement for an audit committee of the board of directors. The SEC has previously sought comment on, but has never adopted, rules to require audit committees for public companies. While the NYSE, NASDAQ and AMEX listing standards do require audit committees for listed companies, they do not specify the duties and responsibilities of audit committees. Thus, they do not amend the duties of directors under state laws which generally permit directors to rely unquestioningly upon the reports of their companies' independent auditors.

While there is a natural tendency for conscientious boards of directors to adopt all well-intended recommendations, especially those proposed by such a highly regarded group as the Blue Ribbon Committee, there are a number of factors that must be appreciated before pursuing this course. Those considerations include the following:

- By adopting and publishing an audit committee charter, the members of the audit committee may be accepting legal responsibilities which, if breached, could entail liability exposures well in excess of their company's D&O coverage.

- The laws of most states not only do not require directors to accept financial reporting responsibilities, but also expressly allow them to rely on the reports of their company's officers and independent auditors.

- Unless a company has adopted a charter amendment expressly exculpating directors for acts of negligence, a corporation might have a duty to pursue audit committee members for any failure to comply with their company's own charter if those omissions result in financial liability to the company; and this obligation could be enforced by a shareholders' derivative action.

- Company counsel owes his or her exclusive duty to

> the corporation and its shareholders and not only is not required to warn directors about their own potential liability exposures, but may not even encourage the company's directors to act in a manner that is adverse to the best interests of the corporation and its shareholders.

With these considerations in mind, the specific recommendations of the Blue Ribbon Committee can be properly evaluated. While these recommendations are not novel and can find their roots in the Treadway Commission Report and in the American Law Institute's 1992 Principles of Corporate Governance, the renewed attention being given to audit committees makes the Blue Ribbon Committee's recommendations important to effective corporate governance.

An Independent Audit Committee

It is hard to argue that a public company should not have an audit committee, that the audit committee should be composed of financially sophisticated individuals, and that at least one of its members have a thorough knowledge of accounting and auditing. These qualities will enable the audit committee members to understand and appreciate the quality of the services their company's independent auditors are providing and the extent to which the company's financial statements not only comply with GAAP but also whether the accounting principles utilized by the company are conservative, aggressive or "preferable." The problem, of course, is finding directors who possess the requisite financial expertise, and this may require many public company boards to recruit one or more new directors to fill this need. Not only is there no reason not to adopt this recommendation now, but it would seem prudent to do so.

The second issue is whether the audit committee need have at least three members. While this seems like an arbitrary requirement, especially for public companies with relatively small boards of directors, the notion of delegating the important responsibilities of audit committee members to at least three persons seems prudent so long as doing so does not unduly dilute the financial sophistication of the committee itself.

The independence requirements suggested by the Blue Ribbon Committee are slightly more controversial since they impose relatively strict limits on who is considered independent. For example, a person who was an employee of the company during the last five years would not be deemed independent; nor would a person who is related to an individual who was employed by the company during the preceding five years be deemed independent. Similarly, a person receiving any compensation from the company other than compensation for board service and a person associated with an entity receiving "significant" compensation from the company would not be independent. Although these independence requirements closely parallel those of the accounting profession, it is not clear that they will necessarily result in an improvement in a company's financial reporting, especially if the company is forced to utilize persons with lesser financial sophistication on its audit committee.

The Audit Committee Charter

One of the more controversial recommendations of the Blue Ribbon Committee is that audit committees should adopt and publicize a charter governing their activities. Careful drafting is crucial to the process of balancing the duties and liabilities of outside directors with their ability to discharge such duties and the level of risk to be assumed. This is because the adoption of a charter may create a public expectation which, if not fulfilled, could form the basis of a liability claim against audit committee members. Conversely, it may also serve to insulate non-committee members from liability. A much better course of action would be to utilize the charter provisions recommended in Appendix C to the Blue Ribbon Committee's report as a guide and to either not report on the activities of the audit committee or only report on those procedures that were actually performed by the audit committee. In fact, audit committees should clearly avoid reporting on procedures which were adopted but not performed unless legally required to do so.

Opinions on Financial Statements

Although the Blue Ribbon Committee recommended that audit committees be required to report on the compliance of their company's financial statements with GAAP, such a report would likely be in violation of state law, possibly subjecting audit committee members to an injunctive action by state accounting regulators. Some commentators have questioned whether the SEC has the power to require

About Vedder Price

Vedder, Price, Kaufman & Kammholz is a national, full-service law firm with approximately 180 attorneys in Chicago, New York City and Livingston, New Jersey.

The Corporate Securities Group

The firm's corporate finance and securities attorneys regularly represent underwriters and issuers, both foreign and domestic, in a wide variety of matters, including:

- debt and equity offerings, including initial public offerings, structured debt financings, aircraft securitizations, dual-class equity structures public company disclosure that violates state law without Congress having authorized such action, thereby preempting state legislation on the subject. For these reasons alone, audit committees should not voluntarily comply with the Blue Ribbon Committee's recommendation to render public opinions on the company's financial statements.

More importantly, by issuing a report that the company's financial statements comply with GAAP, the audit committee would be assuming substantial potential liabilities for little or no compensation. This is especially foolish in light of the fact that the audit committee will not have audited the company's financial statements so that any opinion which it expresses will have little reasonable basis. While this creates something of a "Catch 22" for the reader who chooses to rely on a representation that no sane person would make, it would almost guarantee a lawsuit against audit committee members every time there was a material error in the company's financial statements.

SAS 71 Reviews

Finally, the Blue Ribbon Committee recommended that every public company retain its outside auditors to perform SAS 71 reviews of its quarterly financial statements prior to their being filed with the SEC. This measure could be helpful in preventing a company's management from adjusting reserves and taking other measures that might "smooth" the reported results of operations, although it is not clear that these reviews would necessarily be cost-beneficial. Nevertheless, for most companies the costs of SAS 71 reviews would not be significant, and in a few cases could prevent embarrassing and potentially damaging misstatements of interim operating results. From an audit committee member's perspective, there is no downside to adopting this recommendation, which would also help demonstrate the audit committee's independence from management.

SSAE 2 Engagements

Surprisingly, not mentioned among the Blue Ribbon Committee's recommendations is the use of SSAE 2 engagements (Reviews and Reports on Internal Controls). In the course of an audit, independent auditors are only required to obtain a general understanding of the client's internal accounting controls as a basis for determining the

and sophisticated preferred stock instruments;

- capital formation, for initial capitalization, financing ongoing operations and acquisitions;
- corporate disclosure, periodic reporting, proxy solicitations, and insider trading and beneficial ownership compliance matters;
- private placement of securities including Rule 144A and Regulation S transactions;
- tender offers, mergers and acquisitions and recapitalizations and restructurings;
- international offerings of securities and compliance by foreign issuers with the U.S. securities laws; and
- litigation, administrative and arbitration proceedings involving various securities fraud claims, disclosure issues and regulatory enforcement matters.

Vedder, Price, Kaufman & Kammholz
A Partnership including Vedder, Price, Kaufman & Kammholz, P.C.

Chicago
222 North LaSalle Street
Chicago, Illinois 60601
312/609-7500
Facsimile: 312/609-5005

New York
805 Third Avenue
New York, New York 10022
212/407-7700
Facsimile: 212/407-7799

New Jersey
354 Eisenhower Parkway
Plaza II
Livingston, New Jersey 07039
973/597-1100
Facsimile: 973/597-9607

extent of the substantive testing that will be performed in order to place the auditors in a position to render their report. In many cases, the auditors will simply conclude that the company's internal controls have one or more weaknesses that preclude them from relying upon those controls in assessing the company's financial statements. In such cases, the company (and the audit committee) will never know just how weak its internal controls may be and how vulnerable the company may be to embezzlements and financial frauds.

To fill this gap, the accounting profession has devised a special engagement to review internal controls, and this engagement is governed by Statement on Standards for Attestation Engagements No. 2 ("SSAE 2"). By periodically (perhaps once every five years) having an SSAE 2 engagement performed, an audit committee member can obtain a realistic assessment of their company's internal controls and thereby better appreciate the weaknesses in the company's financial reporting system. While SSAE 2 engagements can involve considerable expense, any person accepting the greater responsibility that audit committee service entails is entitled to have the company provide him or her with reliable information concerning the financial reporting system that he or she is charged with overseeing. Moreover, failure to have an SSAE 2 engagement may run foul of the 1995 *Caremark International* decision of the Delaware Chancery Court, which emphasizes the increased duty of directors to oversee corporate compliance and to have adequate controls in place.

If you have any questions regarding this topic, please contact the author, Dan L. Goldwasser at (212) 407-7710, Jennifer R. Evans at (312) 609-7686 or Steven J. Gray at (312) 609-7528.

- Return to: Corporate Securities
- Return to the Vedder Price: Publications Page.
- Return to: Top of Page.

Home | Legal Services | Attorneys | **Publications** | Recruiting | Seminars | Speakers | Links | Contact Us | Search
Top of Page