

SEC ADOPTS NEW AUDIT COMMITTEE DISCLOSURE RULES
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In December 1999, the Securities and Exchange Commission (“SEC”) adopted new rules and amended its existing rules relating to disclosure of activities conducted by corporate Audit Committees.¹ These rules became effective on January 31, 2000 and, among other things, will require additional disclosure in proxy and information statements for shareholder votes held after December 15, 2000, as well as review of interim financial statements by independent auditors, prior to filing on Form 10-Q or 10-QSB, for fiscal quarters ending on or after March 15, 2000. These new rules and amendments are intended to strengthen the role of corporate Audit Committees in overseeing the financial reporting process, to improve disclosure relating to Audit Committees, and to enhance the reliability and credibility of financial statements of public companies. The new rules apply to most reporting companies, including small businesses that are required to file proxy materials and quarterly reports on Forms 10-Q or 10-QSB.

In adopting the rules, the SEC considered recommendations made by the Blue Ribbon Committee on the Effectiveness of Corporate Audit Committees (the “Blue Ribbon Committee”), which was formed in 1998 at the SEC’s request, and was sponsored by the New York Stock Exchange (“NYSE”) and the National Association of Securities Dealers (“NASD”). The SEC, NYSE and NASD were addressing concerns about recent changes in capital markets, such as the increasing number of investors, the speed and manner in which investors receive information, and the quality of financial reporting. Specifically, the SEC was concerned about increasing pressure on public companies to meet earnings expectations, which could lead to “inappropriate ‘earnings management,’ the practice of distorting the true financial performance of a company.”² Because of the Audit Committee’s role in overseeing and monitoring management’s and the independent auditors’ participation in the financial reporting process, the SEC felt that Audit Committees would be best able to ensure the integrity of our capital markets.

Pre-Filing Review of Quarterly Financial Statements. The SEC now requires companies to have their interim financial statements reviewed by an independent public accountant before filing a Form 10-Q or 10-QSB. In conducting the review, the auditors are required to follow professional standards and procedures for conducting such reviews, as established by generally accepted auditing standards, as the same may be modified or supplemented by the SEC.³ The SEC believes that the interim review by independent auditors will facilitate early identification and resolution of material accounting and reporting issues by involving auditors earlier in the year, thereby reducing potential restatements and other year-end adjustments. The new rules do not require any review by independent auditors of quarterly financial information, such as a company’s “earnings release,” that is released to the public before the filing of a Form 10-Q or 10-QSB.

Inclusion of Supplementary Financial Information. The SEC also amended Item 302(a) of Regulation S-K to apply to all reporting companies, regardless of size or public float,

except small business issuers filing on small business forms. Item 302(a) requires disclosure of certain supplemental financial information (selected quarterly financial data, such as net sales, gross profit, etc.) for the two most recent fiscal years, and also requires at fiscal year end certain reconciliations and descriptions of adjustments made to quarterly information previously reported in any Form 10-Q. Prior to enactment of the amendment, Item 302 applied only to certain large, widely-held companies meeting certain tests (market capitalization, share price, etc.) The selected financial data should be reviewed by the independent auditors in accordance with SAS 71, but the review can be conducted during the annual audit at year end.

Audit Committee Reports. The SEC now requires reporting companies to include an Audit Committee Report in each annual proxy and information statement relating to the election of directors. In its Report, the Audit Committee must state whether it has: (1) reviewed and discussed with management the company's audited financial statements; (2) discussed with the company's independent auditors the matters required to be discussed by SAS 61;⁴ (3) received from the auditors the written disclosures and letter relating to the auditors' independence required by ISB Standard No. 1,⁵ and discussed with the auditors the auditors' independence; and (4) based upon the foregoing review and discussions, state whether the Audit Committee has recommended to the company's Board of Directors that the audited financial statements be included in the company's annual report. The Audit Committee Report must appear above the names of each Audit Committee member. If a company does not have an Audit Committee, the board committee responsible for oversight of the audit function, or the full board of directors, must provide the same disclosure.⁶

Safe Harbor. The SEC has stated that it did not intend to subject Audit Committee members to increased liability, which could have the effect of discouraging qualified individuals from serving on Audit Committees. Accordingly, the SEC provided a "safe harbor" from certain liabilities under the federal securities laws for the disclosures contained in Audit Committee Reports. Such disclosures will not be deemed to be soliciting materials filed with the SEC, unless a company specifically requests otherwise or incorporates the disclosures by reference into another filing under the Securities Act of 1933 or the Securities Exchange Act of 1934. The safe harbor, however, does not extend to private litigation.⁷

Audit Committee Charters. In addition to the Audit Committee Report described above, reporting companies must also disclose in their proxy statements whether the Audit Committee is governed by a written Audit Committee charter. If so, a copy of the charter should be included as an appendix to the proxy statement at least once every three years.⁸ Although the SEC does not require companies to adopt Audit Committee charters, or dictate the contents to be included if such charters are adopted, the NYSE, NASD and the American Stock Exchange ("AMEX") have revised their listing standards to require Audit Committees to "(1) adopt a formal written charter that is approved by the full board of directors and that specifies the scope of the committee's responsibilities, and how it carries out those responsibilities...; and (2) review and reassess the adequacy of the audit committee's charter on an annual basis."⁹

Independence of Audit Committee Members. As the Blue Ribbon Committee noted, directors without financial, family or other ties to management are able to be more objective in their evaluation of management's activities, including audit and disclosure practices. The SEC believes that shareholders should be informed about the independence of Audit Committee members and, accordingly, has imposed new disclosure rules toward that end. Under Item

7(e)(3) of Schedule 14A, companies whose securities are listed on the NYSE or AMEX or quoted in Nasdaq must disclose in their proxy statements whether the Audit Committee members are independent (as defined in the applicable listing standards), or provide certain information about any directors who are not independent. Specifically, the proxy statement must describe the nature of the relationship that makes the director not independent, and the reasons for the Board's determination that the director's service on the Committee was in the best interests of the company. Companies (including small business issuers) whose securities are not listed on the NYSE or AMEX or quoted on Nasdaq must provide similar disclosure, but may select which listing standards to apply, so long as the same standards apply to all Audit Committee members.

Self-regulatory Organizations. In addition to the rules adopted by the SEC, the NYSE, AMEX, NASD and the American Institute of Certified Public Accountants Auditing Standards Board have issued rules implementing the recommendations of the Blue Ribbon Committee. For example, the NYSE, NASD and AMEX imposed the listing standards relating to independence that are referred to above, as well as certain financial literacy requirements, on Audit Committee members. Further information about these rules, or the subject matter of this article, is available upon request to the author.

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¹ See SEC Release No. 34-42266.

² Id.

³ Rule 10-01(d) of Regulation S-X and Item 310(b) of Regulation S-B.

⁴ Statement on Auditing Standards No. 61.

⁵ Independence Standards Board No. 1, *Independence Discussions with Audit Committees*.

⁶ Item 306 of Regulation S-K.

⁷ Id.

⁸ Item 7(e)(3) of Schedule 14A.

⁹ SEC Release No. 34-42266, note 59.