

**MEMO# 11325**

October 20, 1999

## **PROPOSALS INTENDED TO IMPROVE EFFECTIVENESS OF AUDIT COMMITTEES**

1 Securities Exchange Act Release Nos. 41987 (October 7, 1999) 64 FR 55648 (October 14, 1999); 41981 (October 6, 1999) 64 FR 55505 (October 13, 1999); 41982 (October 6, 1999) 64 FR 55510 (October 13, 1999); and 41980 (October 6, 1999), 64 FR 55514 (October 13, 1999). Auditing Standards Board Exposure Draft, Amendments to SAS 61 and SAS 71 (October 1, 1999). [11325] October 20, 1999 TO: ACCOUNTING/TREASURERS COMMITTEE No. 36-99 CLOSED-END INVESTMENT COMPANY COMMITTEE No. 36-99 SEC RULES COMMITTEE No. 81-99 RE: PROPOSALS INTENDED TO IMPROVE EFFECTIVENESS OF AUDIT COMMITTEES

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The Securities and Exchange Commission, the New York and American Stock Exchanges, Nasdaq and the Auditing Standards Board recently released rule proposals intended to improve the effectiveness of corporate audit committees. These proposals are in response to recommendations of the NYSE/NASD Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees issued earlier this year. The SEC proposals require the audit committee to include a report in proxy statements indicating whether it has reviewed the financial statements and discussed them with management and auditors. The exchange rule proposals require audit committees to adopt a formal written charter and to assess the adequacy of the charter annually. The exchange rule proposals also require that audit committees be composed of at least three independent directors, each of which is financially literate, and at least one of which has accounting or related financial management expertise. The ASB proposals would amend Statements on Auditing Standards No. 61, Communication with Audit Committees ("SAS 61"), to require the auditor to discuss certain information relating to the auditor's judgements about the quality, not just the acceptability, of the company's accounting principles with the audit committee. The SEC and exchange proposals described above apply to closed-end investment companies. The SEC proposals do not apply to open-end investment companies, however, the Commission requests comment on whether they should be applied to open-end funds. The ASB proposal described above would apply to audits of all investment companies. Copies of the proposals are attached and are summarized below.<sup>1</sup> Comments on the exchange proposals are due by November 3. Comments on the SEC proposals are due by November 29. Comments on the ASB proposal are due by November 30. If you have any ideas or suggestions that you would like the Institute to consider including in its comment letters on the SEC and the exchange proposals, please contact Marguerite Bateman at 202/326-5813 or [bateman@ici.org](mailto:bateman@ici.org) before October 27. If you have any comments on the ASB proposal, please contact Greg Smith at 202/326-5851 or [smith@ici.org](mailto:smith@ici.org) before November 12. I. SEC Proposals Audit Committee Report Proposed new Item 306 of Regulation S-K and Item 7(e)(3) of Schedule 14A would require that the audit committee provide a report in the company's proxy statement relating to an annual meeting at which directors are elected. The report

would disclose whether the audit committee has reviewed and discussed the audited financial statements with management and discussed certain matters with the independent auditors. Specifically, audit committees would be required to state whether: The audit committee has reviewed and discussed the audited financial statements with management; the audit committee has discussed with the independent auditors the matters required to be discussed by SAS 61; the audit committee has received the written disclosures and the letter from the independent auditors required by Independence Standards Board Standard No. 1, Independence Discussions with Audit Committees ("ISB No. 1"), and has discussed with the auditors the auditors' independence; and, anything came to the attention of the members of the audit committee, as a result of the review and discussions described above, that caused them to believe that the audited financial statements included in the company's annual report contain an untrue statement of material fact, or omit to state a material fact necessary to make the statements not misleading. The amendments would require that the new disclosures appear over the printed names of each member of the audit committee. The proposing release notes that the disclosures will help inform shareholders of the audit committee's oversight with respect to financial reporting, and underscore the importance of the audit committee's participation in the financial reporting process. Further, the amendments are intended to reinforce the audit committee's awareness and acceptance of its responsibilities. The proposing release requests comment on whether the proposed disclosure would provide useful information to shareholders, and would reinforce the audit committee's awareness and acceptance of its responsibilities. The release also requests comment on whether additional disclosure should be required regarding auditor independence.

**Audit Committee Charters** The proposals would require companies to disclose in their proxy statements whether their audit committee is governed by a charter. In addition, if the company has a charter, a copy of the charter would have to be included as an appendix to the proxy at least once every three years. The release notes that these disclosures should help shareholders assess the role and responsibilities of the audit committee, and help focus committee members on their responsibilities. The release requests comment on whether disclosure of the audit committee charter would be useful to investors. As an alternative, would a plain English summary of the charter suffice? Should the audit committee be required to disclose whether it has complied with the charter?

**Safe Harbors** The proposals include "safe harbors" intended to address liability concerns associated with the new disclosures. The safe harbors appear in proposed paragraph (c) of Item 306 of Regulation S-K and paragraph (e)(v) of Item 7 of Schedule 14A. The release notes that to the extent the proposed disclosure requirements would result in more clearly defined procedures for, and disclosure of, the operation of the audit committee, liability claims alleging breach of fiduciary duties under state law actually may be reduced.

**Pre-filing Review of Quarterly Financial Statements** The proposals would amend Rule 10-01(d) of Regulation S-X to require that a company's interim financial statements be reviewed by an independent public accountant prior to the company filing its Form 10-Q with the Commission. The independent accountant would be required to follow professional standards for review engagements, as established by generally accepted auditing standards. Investment companies would not be subject to this pre-filing review requirement. However, the release requests comment on whether a closed-end fund's semi-annual financial statements should be reviewed by independent auditors before being sent to shareholders.

**Application to Investment Companies** The release notes that the proposed audit committee disclosures would apply to closed-end funds. Further, the proposals are intended to work in conjunction with the listing standards of the exchanges that impose requirements on listed companies for their audit committees. Because mutual funds are not subject to the listing standards of an exchange that require companies to have audit committees, the Commission decided to exclude open-end funds from the

proposals. However, the release requests comment on whether any or all of the proposals should apply to investment companies.

## II. Exchange Proposals

The NYSE, AMEX and NASD have proposed to amend their listing standards. The proposals would require that: a) audit committees include at least three members, comprised solely of independent directors who are financially literate; b) at least one member of the audit committee have accounting or related financial management expertise; and c) companies adopt a written audit committee charter that outlines certain specified responsibilities of the audit committee. Further, the proposed amendments implement a more demanding definition of "independence" for audit committee members. The NASD and AMEX proposals are substantially similar. However, the NASD/AMEX proposals differ in certain respects from the NYSE proposal. These proposals are outlined below.

### Composition/Expertise of Audit Committee Members

The exchange rule proposals require an audit committee of at least three members. Also, the audit committee must be comprised solely of independent directors. The NYSE proposal requires each audit committee member to be financially literate, as such qualification is interpreted by the company's board of directors in its business judgement. Further, at least one member of the audit committee must have accounting or related financial management expertise, as the Board of Directors interprets such qualification in its business judgement. The NASD/AMEX proposal indicates that audit committee members must be able to read and understand fundamental financial statements, and that at least one member have past employment experience in finance or accounting, professional certification in accounting, or other comparable experience or background. The proposed rules include an exception whereby one non-independent director may serve on the audit committee, provided that the board determines that it is required by the best interests of the corporation and its shareholders, and the basis for the determination is disclosed in the proxy statement.

### Audit Committee Charter

The exchange rule proposals require a formal, written audit committee charter. The charter must specify: a) the scope of the committee's responsibilities, including structure, process and membership requirements; b) that the outside auditor is ultimately accountable to the Board and the audit committee; and, c) the committee's responsibility for receiving a formal written statement from the outside auditor delineating all relationships between the auditor and the company, consistent with ISB No. 1, and for taking appropriate action to ensure the independence of the outside auditor.

### Independence of Audit Committee Members

The exchange proposals augment the current definition of independent director by specifying certain relationships that would disqualify a director from being considered independent. Specifically, the following directors would not be considered independent: a director who is employed by the corporation or any of its affiliates for the current year or any of the past three years; a director who is a member of the immediate family of an individual who is, or has been in any of the past three years, employed by the corporation or any of its affiliates as an executive officer; and, a director who is employed as an executive of another entity where any of the company's executives serve on that entity's compensation committee. The proposed rules specify certain business relationships between the director and the company (e.g., consulting relationships) which would not disqualify the director from being considered independent.

## III. ASB Proposals

### SAS 61, Communication with Audit Committees

Proposed amendments to SAS 61 would require the auditor to discuss certain information relating to the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles with the audit committee of all SEC registered companies. This discussion would include such matters as the consistency of application of the entity's accounting policies and the clarity, consistency, and completeness of the entity's accounting information contained in the financial statements and related disclosures. Further, the proposed amendments would encourage a three-way discussion among the auditor, management, and the audit committee and introduce documentation requirements to verify that the

discussion took place. The proposed amendments to SAS No. 61 will be effective for audits of financial statements for periods ending on or after December 15, 2000. Gregory M. Smith  
Director - Operations/ Compliance & Fund Accounting Attachments

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