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ALERT

Revised Audit Committee Requirements

The SEC's new rule proposal for audit committees would implement the mandates in the Sarbanes-Oxley Act and prohibit the listing of companies that fail to comply with the Act's and the SEC's requirements.¹ The proposal would add detail to the Act's provisions on the independence of audit-committee members, and it requests comments on a wide range of potential requirements.

The Act requires the SEC to adopt final rules no later than April 26, 2003. Comments on the proposal are due by February 18, 2003.

THE THREAT OF DELISTING

The Sarbanes-Oxley Act requires the SEC to direct the national securities exchanges and association to prohibit the listing of any company not in compliance with the Commission's requirements for audit committees. The requirements cover the independence of audit committee members, the audit committee's responsibilities to select and oversee the independent accountant, the audit committee's authority to engage advisors, funding for the audit committee to pay the

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(1) SEC Release No. 33-8173, Standards Relating to Listed Company Audit Committees, January 8, 2003, available at www.sec.gov/rules/proposed/34-47137.htm. The release responds to Section 301 of the Sarbanes-Oxley Act.

independent auditor and any outside advisors it engages, and procedures for handling complaints about accounting, internal control, and auditing matters (“whistleblower” communications).

Listed companies would be required to notify the relevant exchange or association promptly when an executive officer becomes aware of material noncompliance. The proposal also directs the exchanges and association to establish procedures to give issuers an opportunity to cure defects that would be a basis for delisting their securities or prohibiting their listing.

Under the SEC’s proposal, the new listing requirements would become operative no later than the first anniversary of the publication of the SEC’s final rule in the Federal Register. The exchanges and association would have to submit proposals for such a mechanism to the SEC within 60 days of the publication of the final rule in the Federal Register, with another 210 days permitted before a version of the submitted proposal must be approved by the Commission.

The requirement would be bounded by the definition of an audit committee, which is the same as the one in the Sarbanes-Oxley Act.² Consistent with the definition, the release makes clear that if the entire board of directors constitutes the audit committee, the proposed rules would apply to that entire board. This can be seen as an incentive to create audit committees of the board.

Both the proposing release and comments made during the SEC’s open meeting suggest that the rule is meant to set a “base-line” for audit committees and that the SEC expects the exchanges and association to add regulations and information on implementation and enforcement.

INDEPENDENT AUDIT COMMITTEE MEMBERS

The SEC’s implementation of the independence requirements in the Sarbanes-Oxley Act is based on the audit-committee member’s compensation and the concept of an “affiliated person.” The proposal distinguishes between investment companies and other issuers and is accompanied by exemptions.

The audit-committee members of non-investment company issuers would not be independent if they accepted, directly or indirectly, any consulting, advisory, or other compensatory fee from the company apart from their roles as members of the board of directors and its committees. A payment of this sort to a spouse or specified family members would be indirect acceptance of the payment. So too would be payments to an entity in which the director is a partner, member, or principal or occupies a similar position and which provides accounting, consulting, legal, investment banking, financial, or other advisory services to the listed issuer. Payments made to all shareholders, such as dividends, would not be prohibited by these provisions.

The proposal notes that the existing and proposed rules of the exchanges and association restrict a broader range of business and personal relationships in the interests of independence. In particular, the Commission notes that the proposal would not preclude independence based on ordinary course commercial business relationships.

A non-investment-company audit-committee member who is an affiliated person of the company or any of its subsidiaries would also not be independent. An affiliated person would be defined as a person that directly, or indirectly through an intermediary, controls the company, is controlled by it, or along with the company is under common control. However, the proposal adds a safe harbor presumption that a person who is not an executive officer, director, or 10% shareholder of the issuer would not be considered a controlling party. A director, executive officer, partner, member, principal, or designee of an affiliate would be considered an affiliate, but serving on a controlled subsidiary’s board of directors does not violate a director’s independence under certain circumstances.

Recognizing the difficulty of appointing independent audit committee members before a company has gone public, the proposed rule would exempt one audit-committee member from the independence requirements for 90 days after the effective date of a company’s initial registration statement. This provision would permit a venture capital firm to continue to have representation on the audit committee during the IPO process.

(2) “A committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and [i]f no such committee exists with respect to an issuer, the entire board of directors of the issuer.”

The SEC requests comments on whether to extend independence tests to “look back” periods before a member’s appointment to the audit committee, to extend prohibited payments to relationships in the ordinary course of business, to modify “safe harbor” tests, and to change the exemption period for initial registrations.

INVESTMENT COMPANY INDEPENDENCE REQUIREMENT

The audit-committee members of investment-company issuers would not be independent if they accepted, directly or indirectly, any consulting, advisory, or other compensatory fee from the company apart from their roles as members of the board of directors and its committees. These members would also not be independent if they were an “interested person,” as that term is defined in the Investment Company Act of 1940.³

RESPONSIBILITIES RELATED TO AUDITS

The proposal makes an already implied clarifying change to the Sarbanes-Oxley specification of audit committee duties with respect to independent auditors. The Act required the committee to be directly responsible for appointment, compensation, and oversight of the accounting firm’s work, including the resolution of disagreements over financial reporting between management and the auditor. The proposal adds the word “retention” to this list to make explicit that hiring authority includes firing authority. In addition, the proposed rule would state that the requirement applies not only to the financial-statement audit, but also to related work and other audit or attest services. If company by-laws or home-country regulation requires shareholder ratification of the independent auditor, the audit committee would issue the nomination or provide the recommendation.

The release’s questions ask whether the Commission should add to the required responsibilities, mentioning the potential responsibility to exercise the same kind of authority over internal auditors.

The proposal would exempt investment companies from the requirement that audit committees select the independent auditor. The requirement would overlap with provisions of the Investment Company Act, which calls for a majority decision

by the disinterested directors on the selection of the independent auditor.

OTHER AUDIT COMMITTEE REQUIREMENTS

The release does not add to the Sarbanes-Oxley Act’s requirements for audit-committee procedures to receive, process, and consider complaints on accounting, internal accounting control, or auditing matters, including confidential, anonymous submissions by employees on questionable accounting or auditing matters. The release does, however, request comments on whether to prescribe more detailed procedures and whether the procedures should be disclosed.

Similarly, the release goes no further than the Act’s empowerment of audit committees to engage outside advisors, but asks whether additional specifications are needed. The requirement recognizes that audit committees may not be equipped to address all accounting, financial reporting, and legal matters, and grants the audit committee the authority to engage independent counsel and other advisors as it determines necessary to carry out its duties.

APPLICABILITY

The proposed requirements would apply to both U.S. and foreign private issuers with listed securities. The release attempts to forestall through exemptions potential conflicts with foreign practices and structures and asks respondents whether broader exemptions are needed. All classes of listed securities would be covered, but additional listings by the same company would not be covered if a class of common equity or similar securities already made the company subject to the proposed requirements. Listings of non-equity securities by consolidated majority-owned subsidiaries of parents subject to the requirements would also be exempt as would certain securities that represent futures products and standardized options.

The rule would apply to listed closed-end and exchange-traded open-end investment companies. Issuers of asset-backed securities and unit investment trusts would be exempt.

The proposal contains specific exemptions from the independence requirements. They include a temporary exemption subse-

⁽³⁾ See section 2(a)(19).



Exemptions for Foreign Private Issuers

The exemptions would permit audit committees to contain employees who are not executive officers if elected or named based on local legal or listing requirements, one foreign government member, and one non-voting, non-chair member with observer status who is a shareholder or representative of a shareholder or group owning more than 50% of the voting securities. Both foreign government and the more than 50% shareholder representatives cannot be executive officers and are subject to the prohibitions on compensatory fees. In the case of two-tier boards of directors, the term “board of directors” would apply to the supervisory or non-management board, which could either form an audit committee or designate the entire board as the audit committee, if its members are independent under the rules. In addition, the audit committee’s responsibility to oversee the audit could be performed by boards of auditors or statutory auditors, out of respect for that practice in some countries.

quent to initial registrations, holding company and majority-owned subsidiary relationships in certain cases, and the unique circumstances faced by foreign private issuers.

DISCLOSURE

Companies that use any of the proposed exemptions, other than the multiple-listing exemption, would have to disclose that fact and their assessment of whether and (if so) how it would materially adversely affect the audit committee’s performance in relation to its obligations under the proposed rule. The disclosure would appear in proxy filings and, at least by reference, in annual report filings.

All issuers, including non-listed issuers, would have to disclose in their proxy reports whether their audit committee members are independent. If the entire board is acting as an issuer’s audit committee, the independence information would have to be disclosed for all members of the board. Listed companies would use the definition of independence from the applicable listing standards. Non-listed companies would make the disclosure by choosing a definition from any adopted by a national securities exchange or association and approved by the Commission and identifying which definition was used.

Companies and their audit committees should not treat the descriptive and summary statements above about the proposed rules as if they are what the SEC will finally adopt. They should consult the final SEC rules and their accounting and legal advisors.

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