

Audit Committees of Boards of Directors:

How Much Responsibility Do They Have?

How Much Responsibility Should They Have?

H

ere is a good model of key provisions for the sort of audit committee charter that corporate governance advocates have promoted in recent years:

The Committee shall be comprised of three or more directors who, in the opinion of the Board of Directors, as evidenced by its election of such Committee members, have no relationship to the company that may interfere with the exercise of independent judgement [sic] as a Committee member. All members of the Committee shall be financially literate or become financially literate within a reasonable period of time after appointment to the Committee, and at least one member of the Committee shall have accounting or related financial management expertise, in each case as interpreted by the Board of Directors.

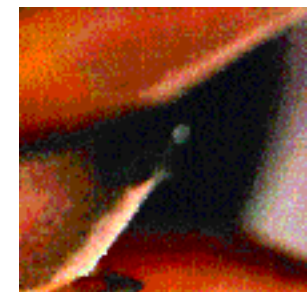
The Committee shall serve as the overseer of the Company's financial reporting process and internal controls. . . .The Committee's principal functions shall include:

Ensure Audit Function Independence

- Recommend to the Board of Directors, for subsequent submission to the shareholders of the Company, the firm to engage as the Company's independent auditor; and, if warranted in the discretion of the Committee, recommend to the Board of Directors the termination of that engagement. . . .
- Review the independent auditor's compensation, the terms of its engagement, and its independence. . . . [I]f necessary, the Committee should take action or recommend that the Board take appropriate action, to satisfy itself of the outside accountant's independence. . . .

Assess Internal Controls and Quality of Financial Reporting

- Discuss with the independent auditor information relating to the auditor's judgments about the quality of the Company's accounting principles, including such matters as the consistency of application of the Company's accounting policies, as well as the



clarity and completeness of the Company's accounting information contained in the financial statements and related disclosures filed with the Securities and Exchange Commission and distributed to the Company's shareholders.

- Review, in consultation with the independent auditor and the executive having responsibility for the internal and contract audit functions, the adequacy of the Company's internal financial controls. Among other things, determine whether these controls provide reasonable assurance that the Company's publicly reported financial statements are presented fairly in conformity with generally accepted accounting principles.
- Review the Company's electronic data processing procedures and controls on a periodic basis. Also review any deficiencies noted by the independent auditor in such electronic data processing procedures and control.
- Approve major changes and other major questions of choice regarding the appropriate accounting principles and practices to be followed when preparing the Company's financial statements for the purpose of making recommendations to the Board of Directors as necessary.

Review Financial Statements

- Review financial statements included in the Annual Report to Shareholders, footnotes, and management commentaries, Form 10-K filings made with the Securities and Exchange Commission prior to release of such statements and filings. . . .
- Publish a written report in the annual proxy statement indicating that (a) the Committee has reviewed and discussed the financial statements with management, (b) the Committee has discussed the quality of the Company's accounting principles as applied in its financial reporting, (c) the Committee has received the written report from the independent auditors delineating all relationships between the auditor and the Company, (d) the

Committee has discussed with the independent auditors their independence and taken or recommended action, if necessary, related to independence concerns and (e) nothing has come to the Committee's attention that would cause them to believe that the financial statements included in the Annual Report on Form 10-K contain an untrue statement or omit a material fact, and thus recommend to the Board that the audited financial statements be included in the Company's Annual Report on Form 10-K. Furthermore, the Committee will take action where necessary to be in compliance with all applicable rules and regulations.

- Review with management the Company's policies and practices for communications with analysts.

Other

- Approve for recommendation to the Board of Directors the Company's policies and procedures regarding compliance with the law and with significant Company policies, including but not limited to, codes of conduct expressing principles of business ethics, legal compliance, the Foreign Corrupt Practices Act, and other matters relating to business conduct, and programs of legal compliance designed to prevent and detect violations of law.
- Review with the general counsel any legal and regulatory matters that may have a material effect on the Company's financial statements, compliance policies, and programs.
- If necessary, institute special investigations and, if appropriate, hire special counsel or experts to assist.
- Perform other oversight duties and responsibilities as may be assigned to the Committee, from time to time, by the Board of Directors of the Company and/or the Chairman of the Board of Directors.
- Review and, to the extent that the Committee determines is appropriate, update this Charter periodically, at least annually, as conditions dictate.

From Enron Corp. Audit and Compliance Committee Charter (as amended Feb. 12, 2001).



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The Enron Charter accurately reflects the current legal and regulatory requirements for audit committees. Yet critics have accused Enron's audit committee of falling asleep at the switch.¹ In the wake of the Enron collapse, there has been a spate of proposals to rewrite the rules and procedures for auditing public companies' books. These proposals include calls for reforming the role of the audit committee.² What, exactly, is the audit committee required to do under the rules currently in effect? Lawyers who counsel public companies should know. This article will answer that question with a review of existing rules regarding audit committees.

Although you may want to see a thorough discussion of some of the latest developments and proposals, such a discussion is not possible in this article because the developments are occurring on a daily basis and this article went into production in early March 2002, so many new developments may have occurred before you will have read this article in May 2002. Nevertheless, we will touch on some recent proposals as of the date of this writing. Is it realistic and workable to expect audit committees to take on much more of the burden of ensuring good corporate governance? We don't think so, and here's why.

BACKGROUND

("SEC") Chairman Arthur Levitt gave a speech called "The Numbers Game."³ In it, he roundly criticized companies and their accountants for practices that he called "accounting hocus-pocus," including "big bath charges," "creative acquisition accounting," "cookie jar reserves," "the abuse of materiality," and "manipulating the recognition of revenue."⁴ Levitt concluded his "Numbers Game" speech with a call for immediate and coordinated action to address what he perceived as widespread abuses in the financial reporting system. One of the reforms that Levitt proposed was to strengthen the audit committees of public company boards of directors. As he put it,

[Q]ualified, committed, independent and tough-minded audit committees represent the most reliable guardians of the public interest. Sadly, stories abound of audit committees whose members lack expertise in the basic principles of financial reporting as well as the mandate to ask probing questions. In fact, I've heard of one audit committee that convenes only twice a year before the regular board meeting for 15 minutes and whose duties are limited to a perfunctory presentation.

Compare that situation with the audit committee which meets twelve times a year before each board meeting; where every member has a financial background; where there are no personal ties to the chairman or the company; where they have their own advisers; where they ask tough questions of management and outside auditors; and where, ultimately, the investor interest is being served.⁵

Although stating that the "SEC stands ready to take appropriate action if that interest is not protected," Levitt nevertheless acknowledged that "a private sector response that empowers audit committees and obviates the need for public sector dictates seems the wisest choice."⁶ He then announced that "the financial community has agreed to accept this challenge" by convening "a 'blue-ribbon' panel" under the sponsorship of the New York Stock Exchange and the National Association of Securities Dealers, Inc.⁷ Levitt predicted that the panel would "develop a series of far-ranging recommendations intended to

get the right people to do the right things and ask the right questions.”⁷⁸

Following a period of study and public hearings, on February 8, 1999, the Blue Ribbon Committee issued its Report and Recommendations on Improving the Effectiveness of Corporate Audit Committees.⁹ The Blue Ribbon Committee Report set forth a “Ten Point Plan to Improve Audit Committee Oversight.”¹⁰

In December 1999, in response to the Blue Ribbon Committee Report, the SEC adopted some new rules, amended some old ones, and approved new listing requirements of the New York Stock Exchange (“NYSE”), the American Stock Exchange (“AMEX”), and the National Association of Securities Dealers, Inc. (“NASD”) (see accompanying sidebar on the Blue Ribbon Committee).¹¹ Those rules, along with some important case law, form the backbone of the current legal and regulatory duties of audit committees of public companies, to which we now turn.

AUDIT COMMITTEE CHARTER

Public companies are required to disclose in their annual proxy statements whether they have an audit committee, and if they do, they must identify each

member, state the number of committee meetings held during the last fiscal year, and describe its functions.¹²

They must also disclose whether their audit committee has adopted a written charter, and if it has, they must append a copy of the charter to the company’s annual proxy statement at least once every three years.¹³

Although this requirement is technically a disclosure rule, in practical reality it is tantamount to codifying as law the existing listing requirement that all listed companies adopt audit committee charters because few companies would want to disclose, in the current environment, that they do not have one.

COMPOSITION OF THE AUDIT COMMITTEE

The listing standards of NYSE, AMEX, and NASD require listed companies to have audit committees.

The NYSE, AMEX, and NASD listing standards also set forth requirements regarding the composition of the audit committee and the independence and expertise of the audit committee members.

NYSE

NYSE has the following independence and qualifications of audit committee member requirements.

THE BLUE RIBBON COMMITTEE’S GUIDING PRINCIPLES¹

In addition to recommending regulatory reforms, the Blue Ribbon Committee also set forth five guiding principles for audit committee best practices. These principles are intended “to serve as building blocks for devising company-specific processes and practices, and ultimately for the committee’s charter.” Here is a summary of the Blue Ribbon Committee’s five guiding principles:

- In recognition of its role in overseeing others who are responsible for the company’s financial reporting, including management, the company’s internal audit department, and the company’s independent auditors, “the audit committee should encourage procedures that promote accountability among these players, ensuring that management properly develops and adheres to a system of sound internal

through their own review, assess management and the internal auditor’s practices.”

- Companies should have “formal mechanisms in place to facilitate confidential exchanges between the internal auditor and the audit committee.” Both the audit committee and the company’s management should support and promote the principle that, if the internal auditors discover problems that management will not address, they have a duty to inform the audit committee.
- “[E]very audit committee should adopt additional voluntary measures to ensure outside auditors’ objectivity.” The specific practices recommended in this regard include regular “open, frank, and confidential” communication between the audit committee and the outside auditors and

Independence Requirement

The audit committee of an NYSE listed company must have at least three independent directors. Directors are considered independent if they have “no relationship to the company which may interfere with the exercise of their independence from management and the company.”¹⁴ In addition, directors who are employees of the company may not serve on the company’s audit committee until three years after the termination of their employment. Partners, controlling shareholders, and executive officers of an organization with a business relationship with the company or directors who have a direct business relationship with the company may serve on a company’s audit committee only if the board determines, in its business judgment, that the relationship does not interfere with the director’s exercise of independent judgment.

A director “employed as an executive of another corporation where any of the company’s executives serves on that corporation’s compensation committee may not serve on the audit committee.”¹⁵ In addition, “[a] director who is an [i]mmediate [f]amily member of an individual who is an executive officer of the company or any of its affiliates cannot serve on the audit committee until three years following termination of such employment relationship.”¹⁶

- The audit committee should engage in candid discussions with management, the inside auditors, and the outside auditors to get behind the numbers. Management should apprise the audit committee of factors affecting the quality of the financial reporting and should specifically discuss with the committee the following items:
 - Company’s financial statements and disclosure schedules before they are filed with the SEC.
 - Any changes in accounting principles and policies, the accounting for significant transactions, and significant variances from budget.
 - Any instances in which management has sought second opinions from outside auditors regarding accounting treatment for particular events or transactions.
 - Management’s response to assessments provided

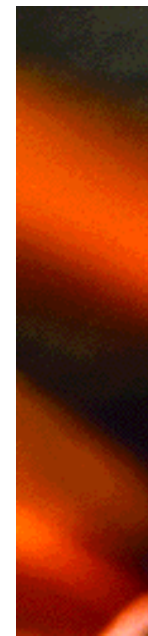
There is a limited exception permitting a single director who is no longer an employee or who is an immediate family member of a former executive officer of the company—and yet who is not considered independent because of the three-year restriction—to be appointed to the audit committee if the board determines that having the director on the audit committee is in the best interests of the company and its shareholders. If the board makes such a determination, the company’s next annual proxy statement must disclose the director’s relationship to the company and the reasons for the board’s determination. As we will see below, some of these exceptions to the independence requirement have come under fire in connection with the Enron debacle.

Qualifications of Audit Committee Members

The NYSE also requires that each member of the audit committee be financially literate or become financially literate within a reasonable amount of time after appointment to the committee. The rules do not spell out the test for financial literacy. It is for the board of directors, in its business judgment, to determine whether a member is financially literate. At least one member of the audit committee of NYSE listed companies must have accounting or

- advisors to ensure that the committee receives all necessary and pertinent information.
- The board should take steps to ensure that the audit committee consists of diligent, knowledgeable, and dedicated directors who are “willing to devote a substantial amount of time and energy to the responsibilities of the audit committee in addition to board responsibilities.” In this regard, the board may decide that “audit committee service merits higher compensation than service on other board committees.” The audit committee should also consider ongoing training and education for its members.

1. Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (1999), available at www.nyse.com/pdfs/blueribb.pdf; see also press release, NYSE Chair Richard Grasso, NASD Chair Frank Zarb, and Blue Ribbon Panel



related financial management expertise. Whether or not a member has the requisite level of expertise is also a matter for the board to determine in its business judgment.

NASD/AMEX

The NASD and AMEX rules are substantially the same with respect to the composition, independence, and qualifications of audit committees. Each requires a domestic listed company to have “an audit committee of at least three members, comprised solely of independent directors, each of whom is able to read and understand fundamental financial statements . . . or will become able to do so within a reasonable period of time after his or her appointment to the audit committee.”¹⁷

NASD AND AMEX REQUIRE THAT MEMBERS OF THE AUDIT COMMITTEES BE “ABLE TO READ AND UNDERSTAND FUNDAMENTAL FINANCIAL STATEMENTS.”

Independence Requirement

To be considered independent, NASD and AMEX require that the director not be an officer of the company and be “free of any relationship that would interfere with the exercise of independent judgment.”¹⁸

NASD and AMEX consider the following persons not independent:

- Director who is or has been, in the last three years, an employee of the company.
- Director who accepted compensation in excess of \$60,000 from the company during the previous fiscal year (other than compensation for serving on the board).
- Director who is an immediate family member of a person who is or has been an executive officer of the company or one of its affiliates in the last three years.
- Director who is a partner in or a controlling shareholder or an executive officer of any for-profit business to which the company made or from which the company received payments in excess of 5 per-

- Director employed as an executive of an other entity where any of the company’s executives serve on that entity’s compensation committee.

According to NASD and AMEX, audit committees may have one member who is not independent (and not an employee or an immediate family member of any employee of the company) if the board, “under exceptional and limited circumstances, determines that membership on the committee by the individual is required in the best interests of the corporation and its shareholders.”¹⁹ If it makes such an exception, the board must disclose, “in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reason for that determination.”²⁰

Qualifications of Audit Committee Members

NASD and AMEX require that members of the audit committees be “able to read and understand

*From this point on . . .
Explore information related to this topic.*

ONLINE:

- “Counseling the Board of Public Companies: New and Recurring Issues,” available on ACCA OnlineSM at www.acca.com/education2k1/am/cm/036.pdf.
- “Director and Officer Responsibilities: An Overview,” available on ACCA OnlineSM at www.acca.com/protected/legres/scities/howard.html.
- C. Russel Hansen Jr., “Assisting the Board in Its Seven Stages of Growth,” *ACCA Docket* 19, no. 4 (2001): 52–64, available on ACCA OnlineSM at www.acca.com/protected/pubs/docket/am01/assist1.php.
- John Howard and Timothy Donovan, “On Duty at the Corporate Helm: An Overview of Director and Officer Responsibilities,” *ACCA Docket* 18, no. 9 (2000): 36–52, available on



fundamental financial statements.”²¹ At least one member of the audit committee must have “employment experience in finance or accounting, requisite professional certification in accounting,” or other experience resulting in “financial sophistication.”²²

ANNUAL REQUIREMENTS

Proxy statements relating to the election of directors must include the audit committee report as set forth in Item 306 of SEC Regulation S-K²³ (the basic SEC disclosure regulation). In such reports, audit committees must disclose whether they have (1) reviewed and discussed the company’s audited finan-

cial statements with management, (2) received the written disclosure and the letter from the independent accountants required by the Independence Standards Board’s Standard No. 1 and discussed with the independent accountants the issue of independence,²⁴ (3) recommended to the board of directors that the audited financial statements be included in the company’s Form 10-K, and (4) discussed with the independent accountants the matters required by SAS 61. See accompanying sidebar for the Statement on Auditing Standards (“SAS”) discussion topics.

The annual proxy statement must also state whether the members of the audit committee are independent as defined in the applicable listing

REQUIRED ANNUAL AGENDA ITEMS

Under Statement on Auditing Standards (“SAS”) No. 61,¹ independent auditors of public companies are required to discuss a number of specific topics with the audit committee at least once a year, including the following:

- Internal controls and the level of responsibility assumed for an audit under generally accepted auditing standards.
- Fact “that an audit conducted in accordance with generally accepted auditing standards is designed to obtain reasonable, rather than absolute, assurance about the financial statements.”²
- “[I]nitial selection of and changes in significant accounting policies or their application.”³
- “[M]ethods used to account for significant unusual transactions.”⁴
- “[E]ffect of significant accounting policies in controversial or emerging areas where there is a lack of authoritative guidance.”⁵
- “[P]rocess used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor’s conclusions regarding the reasonableness of those estimates.”⁶
- Adjustments arising from the audit that “individually or in the aggregate could have a significant effect on the entity’s financial reporting” (includ-

- Auditors’ responsibility for information prepared by management that accompany financial statements, such as management’s discussion and analysis.
- Quality of the company’s accounting principles used to prepare financial reports.⁸
- Disagreements between the auditors and management about matters that individually or in the aggregate could be significant to the entity’s financial statements.
- Consultation between management and other accountants regarding auditing and accounting matters.
- Major issues discussed by the auditors and management before retention.
- Difficulties encountered by the auditors in dealing with management related to the performance of the audit.

1. American Institute of Certified Public Accountants (“AICPA”), Communication with Audit Committees, Statement on Auditing Standards (“SAS”) No. 61, 1988.

2. *Id.*

3. *Id.*

4. *Id.*

5. *Id.*

6. *Id.*

standards of NYSE, AMEX, or NASD.²⁵ Nonlisted companies that have audit committees may choose any of the three listing standards and must disclose and consistently apply to all members of the committee the standard chosen.²⁶ If the board of directors of a listed company appoints a director to its audit committee who is not independent in accordance with the applicable listing standard, the nature of the relationship that makes that individual not independent and the reason for the board's determination to appoint the nonindependent director must be disclosed.²⁷

QUARTERLY REQUIREMENTS

The SEC now requires that interim financial statements be reviewed by independent accountants.²⁸ SAS 71 sets forth the standards for such review. In addition, SAS 71 sets forth the circumstances when the accountant must consider whether to communicate to the audit committee information discovered in connection with the review.²⁹

Under SAS 71, if, in conducting a review of interim financial statements, an independent accountant believes that interim financial information filed or to be filed with "specified regulatory agencies" (defined as the SEC, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Federal Reserve System, and Office of the Thrift Supervision) is "probably materially misstated," an escalating response is required. Initially, the independent accountant is required to bring the matter to the attention of the company's management. If management does not respond appropriately, the independent accountant must bring the issue to the attention of the audit committee. If the audit committee "does not respond in a timely or appropriate manner," SAS 71 directs the independent accountant to "consider" these courses of action:

- Resign from the interim financial information engagements.
- Resign from the related audit engagement.
- In considering either course of action, consult with legal counsel.³⁰

- Fraudulent acts discovered during the engagement, except those that are clearly inconsequential.
- Illegal acts discovered during the engagement, except those that are clearly inconsequential.
- So-called reportable conditions (meaning material weaknesses in internal controls discovered during the review).
- Other matters discussed in SAS 61 that may relate to interim financial information. (See sidebar on page 56.)

Although, except in the instances cited above, there is no legal requirement that the audit committee be involved in the quarterly review, many companies make it part of their quarterly audit committee agenda.


THE ANNUAL PROXY STATEMENT MUST ALSO STATE WHETHER THE MEMBERS OF THE AUDIT COMMITTEE ARE INDEPENDENT AS DEFINED IN THE APPLICABLE LISTING STANDARDS OF NYSE, AMEX, OR NASD.

THE CAREMARK CASE

You can see that the most specific requirements for audit committee members grow out of disclosure rules in the federal securities laws. Yet it is also important to consider the role of the audit committee in connection with the board's more general duties under state corporate law.

Consider the well-publicized *Caremark* case.³¹ Chancellor Allen's decision in *Caremark* put directors on notice that they could be held personally accountable for failing to monitor their companies to assure that the companies are functioning lawfully in pursuit of corporate purposes. *Caremark* made clear that directors must assure that "information and reporting systems exist in the organization that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation's compliance with law and its business performance."³²

Under *Caremark*, the duty to act in good faith



Caremark, only a sustained or systematic failure of the board to exercise oversight, such as an utter failure of the board to attempt to assure that a reasonable information and reporting system exists, will establish the lack of good faith that is a necessary condition to liability.”³⁴ It appears that the standard that *Caremark* requires for a finding of personal liability is more than mere negligence and probably even more than gross negligence. It is one approaching bad faith.

In practice, it often falls to the audit committee to satisfy the *Caremark* duty of ensuring the adequacy of a company’s information and reporting systems. A properly functioning audit committee will go a long way toward filling that bill, largely through its periodic meetings with the company’s internal audit head and outside auditors.

If the audit committee discharges these duties in good faith and in reasonable reliance on the information that it receives from management and from out-

side auditors, what else could one ask of an audit committee? If some of the recent proposals made in the wake of the Enron situation are adopted, the answer to this question may come as a surprise to audit committee members.

RECENT PROPOSALS

Because of Enron, corporate governance advocates have turned their attention to the audit committee. We believe that many of the recent proposals are useful and should be adopted by public companies. Other proposals are troublesome and may set requirements that are impossibly high for audit committee members to meet.

Independence

Many proposals involve strengthening the independence requirements for audit committees.³⁵ As discussed above, the NYSE, AMEX, and NASD listing standards allow a company’s board of directors the discretion to appoint nonindependent directors to the audit committee. This area seems to us to be a reasonable place to focus reform efforts.

A requirement that all audit committee members be independent, with no discretion to appoint non-independent directors to audit committees, appears to be in order. If such a requirement were in place, “half of Enron’s six member audit committee would have been barred from service.”³⁶ At a minimum, stricter independence requirements would avoid the appearance of impropriety that comes from having an audit committee member with an apparent conflict of interest. That change could go a long way in restoring investor confidence in the audit committee’s role in financial reporting.

Mandatory Number of Audit Committee Meetings

Some have expressed the view that audit committees should be required to hold a minimum number of meetings each year.³⁷ Enron disclosed that its audit committee met five times in the year 2000.³⁸ It is difficult to see what holding more meetings would have accomplished for Enron or what a mandatory number of audit committee meetings

POST-ENRON PRACTICE RESOURCES AVAILABLE ON ACCA ONLINESM

ACCA is gathering practice resources online to address issues that members are raising specific to the recent and continuing events at Enron. The material and information assembled to date are on ACCA OnlineSM at www.acca.com/legres/enron/index.php. Thanks to the members of ACCA’s Corporate and Securities Law Committee for their assistance in identifying relevant issues and in sharing their available resources. The committee is also hosting an online discussion board that you can use to raise questions and discuss issues (at the above address and open to ACCA members only). Finally, we ask that you help us to expand these resources. Let us know what we should add, such as links to related websites, sample forms and policies, recent articles, press releases, regulatory statements, or anything else that would benefit members. Email your suggestions to ACCA’s

the board and its committees is normally a matter of internal corporate governance, disciplined by the directors' overriding fiduciary duties of care and of loyalty. We oppose mandatory meeting schedules.

Qualifications

In the wake of the Enron collapse, SEC Chairman Harvey Pitt has charged that many companies have "audit committees that often do not understand the accounting principles employed by management, or the consequences of using different principles or different assumptions."³⁹ The existing qualification

IN MOST CASES, A REASONABLY COMPETENT DIRECTOR ACTING IN GOOD FAITH WILL DISCHARGE HIS OR HER DUTIES EFFECTIVELY.

requirements for audit committee members, discussed above, are designed to assure that they understand the company's financial statements and have some degree of sophistication concerning the financial reporting process. This requirement is reasonable and, in our view, adequate. It is not clear what additional experience and qualification can, as a practical matter, be required of audit committee members. We note in this regard that the chairman of Enron's audit committee, Mr. Jaedicke, is a former professor of accounting at Stanford University.

Disciplinary Action

The AFL-CIO has proposed that the directors of Enron be held accountable and barred from holding positions on the boards of other companies.⁴⁰ This proposed requirement seems a draconian response, even allowing a reasonable discount for hyperbole.

Certainly, audit committee members who breach the duty imposed by *Caremark* can and should be held accountable. Is anyone certain, however, exactly what happened in Enron? It would seem premature to reach such a judgment. The various parties reviewing the Enron situation and considering the degree to which the Enron audit committee was at fault, including the SEC, several prosecutors, and

corporate action. Terrible results and even management fraud should not create a presumption that outside directors breached their duties.

As the court stated in *Caremark*, "[o]nly a sustained or systematic failure of the board to exercise oversight—such as an utter failure of the board to attempt to assure a reasonable information and reporting system exists—will establish the lack of good faith that is a necessary condition to liability." In most cases, a reasonably competent director acting in good faith will discharge his or her duties effectively. Outside directorships, including audit committee membership, should not be reserved for experts working full-time or nearly full-time on the financial reporting issues of a company.

CONCLUSION

Every in-house counsel who deals with issues of corporate governance should be familiar with the legal requirements for board audit committees. These requirements include the recently adopted SEC disclosure rules and the new substantive rules of the NYSE, AMEX, and NASD relating to board audit committees. In addition, board counsel should keep in mind the important role that the audit committee plays in discharging the "information systems and monitoring" duties discussed in the *Caremark* case.

In the current environment, when board audit committees are likely to come under closer scrutiny than ever, it would behoove every public company to take inventory of its policies and procedures relating to the composition and work of the audit committee. It is useful to look at the issues in categories that lend themselves to pragmatic application, such as the following:

- Composition of the audit committee, personal qualities and professional qualifications of its members, and advisability of ongoing training.
- Content of the audit committee charter
- Standing items that should be on the audit committee's agenda at least every quarter under SAS 71 (to the extent that the audit committee oversees or monitors the independent accountants' review of interim financial statements) and every year

- Role that the audit committee plays in ensuring the existence and proper functioning of information and reporting systems “that are reasonably designed to provide to senior management and to the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation’s compliance with law and its business performance.”⁴¹ A

NOTES

1. See, e.g., Joann S. Lublin, *Inside, Outside Enron, Audit Panel Is Scrutinized*, WALL ST. J., Feb. 1, 2002, at 1, col. 1, available at 2002 WL-WSJ 3384720 (“‘It’s the worst audit committee I have ever seen,’ asserts John Nash, president emeritus of the National Association of Corporate Directors.”).
2. See, e.g., Nannette Byrnes, Mike McNamee, Diane Brady, & Louis Lavelle, *The Enron Scandal, Accounting in Crisis*, BUS. WEEK, Jan. 28, 2002, at 44, available at 2002 WL 9359682.
3. “The Numbers Game,” Remarks at the NYU Center for Law and Business (Sept. 28, 1998), available at www.sec.gov/news/speech/speecharchive/1998/spch220.txt.
4. *Id.*
5. *Id.*
6. *Id.*
7. *Id.*
8. *Id.*
9. Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (1999), available at www.nyse.com/pdfs/blueribb.pdf; see also press release, NYSE Chair Richard Grasso, NASD Chair Frank Zarb, and Blue Ribbon Panel Cochairs Ira Millstein and John Whitehead Announce “Ten Point Plan” to Improve Oversight of Financial Reporting Process, available on NASD website (www.nasd.com) under News & Highlights, Archives, Press Releases, Feb. 8, 1999.
10. The Blue Ribbon Committee’s 10 recommendations were the following:
 1. To revise the definition of director independence for service on the audit committee.
 2. To require that listed companies with a market capitalization of \$200 million have audit committees consisting solely of independent members.
 3. To mandate that audit committees have at least three independent directors, “each of whom is financially literate . . . or becomes financially literate”
 4. To mandate that companies have a formal written audit committee charter, which they reassess on a periodic basis.
 5. To mandate that companies disclose in their proxy statements whether they have adopted a formal written charter for the audit committee and make certain related disclosures.
 6. To amend the listing rules of NYSE NASD to require that every listed company’s audit committee charter “specify that the outside auditor is ultimately accountable to the board of directors and the audit committee as the representatives of shareholders, and that these shareholder representatives have the ultimate responsibility to select, evaluate and, where appropriate, replace the outside auditor.”
 7. To mandate that the audit committee annually
 - (a) receive from the outside auditors a statement specifying the relationships between the company and the audit firm, consistent with Independence Standards Board Standard 98-1, and
 - (b) discuss with the auditors “any disclosed relationships or services that may impact the objectivity and independence of the auditor” and take “appropriate action to ensure the independence of the outside auditor.”
 8. To amend the Generally Accepted Auditing Standards (“GAAS”) to require a company’s outside auditors to discuss with the audit committee “the auditor’s judgments about the quality, not just the acceptability, of the company’s accounting principles as applied in its financial reporting.”
 9. To require SEC reporting companies to include in their form 10-K Annual Reports a letter from the audit committee to shareholders, with specified disclosures.
 10. To require SEC reporting companies to have their auditors review their interim financial statements before the company files its quarterly reports on Form 10-Q.
 11. See Gregory S. Rowland, Note, Earnings Management, the SEC, and Corporate Governance: Directors Liability Arising from the Audit Committee Report, 102 Colum. L. Rev. 168, 173–74 (2002).
 12. See 17 C.F.R. 240.14a-101 (2001).
 13. See *id.*
 14. The NYSE rules with respect to audit committees are at § 303 of the NYSE Listed Company Manual.
 15. *Id.*
 16. *Id.*
 17. The NASD rules with respect to audit committees are at §§ 4200 and 4310 of the Marketplace Rules in the NASD Manual; the AMEX rules with respect to audit committees

19. *Id.*
 20. *Id.*
 21. *Id.*
 22. *Id.*
 23. 17 C.F.R. § 229.306 (2001).
 24. Independence Standards Board Standard No. 1 requires that, at least annually, an independent auditor of a public company—
 - a. Disclose to the audit committee, in writing, all relationships between the auditor and its related entities, on the one hand, and the company and its related entities, on the other hand, which in the auditor's professional judgment may reasonably be thought to bear on independence.
 - b. Confirm in writing that, in its professional judgment, it is independent within the meaning of the securities laws.
 - c. Discuss the auditor's independence with the audit committee. Independence Standards Board Standard No. 1 (Indep. Standards Bd. 1999).
 25. 17 C.F.R. § 240.14a-101 (2001).
 26. See *id.*
 27. See *id.*
 28. See 17 C.F.R. §§ 210.10-01, 228.310(b) (2001).
 29. See American Institute of Certified Public Accountants ("AICPA"), Interim Financial Information, Statement on Auditing Standards No. 71, 1992.
 30. *Id.*
 31. *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).
 32. *Id.* at 970.
 33. *Id.* at 971.
 34. *Id.*
 35. See, e.g., Byrnes, McNamee, Brady, & Lavelle, *supra* note 2, at 48.
 36. See *id.*
 37. See Louis Lavelle, *Enron: How Governance Rules Failed*, *Bus. Week*, Jan. 21, 2002, at 29.
 38. See Andrew Hill & Michael Peel, *Companies & Finance: Independent Directors Now Face Criticism*, *Fin. Times*, Jan. 28, 2002, at 20.
 39. SEC Chairman Harvey L. Pitt, Remarks at the 29th Annual Securities Regulation Institute (Jan. 23, 2002).
 40. See Hill & Peel, *supra* note 27, at 20.
 41. *Caremark*, 698 A.2d at 970.
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