

The Sarbanes-Oxley Act of 2002

And Current Proposals by NYSE, Amex and NASDAQ

Board and Audit Committee Roles
in the Era of Corporate Reform: A White Paper



This white paper provides general or summary information about aspects of the Sarbanes-Oxley Act of 2002, and current and proposed rules, regulations or standards of the U.S. Securities and Exchange Commission and national securities exchanges and associations. The information and considerations presented do not constitute the provision of legal advice. Boards of directors, audit committees and companies are encouraged to reference the foregoing statute, rules, regulations and standards, and to consult with legal counsel concerning their responsibilities with respect to applicable provisions thereof.

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I. Preface

During the past two years, a series of accounting and management scandals within major companies undermined investor confidence in corporations and others serving the capital markets.

In response to the crisis, the U.S. Congress passed legislation, the Sarbanes-Oxley Act of 2002, that establishes many new requirements, including those governing the composition and responsibilities of audit committees. SEC rules implementing many provisions of Sarbanes-Oxley have just been finalised or proposed. Major national securities exchanges and associations – The New York Stock Exchange (NYSE), The American Stock Exchange (Amex) and The NASDAQ Stock Market (NASDAQ) – have proposed reforms to their own membership standards as well. The responses, individually and collectively, are far-reaching in scope. (For presentation convenience, NYSE, Amex and NASDAQ are collectively referred to as “Listing Markets.”)

Our system of corporate governance is compelled to improve. Checks and balances are being reinforced, with substantive new rules now in effect and further proposals on the table. From this, boards and their audit committees are emerging as prime agents of good governance. We believe this to be a vital role, and others are voicing similar opinions.

Tailoring a Response to the Mandates

The new and proposed reforms – though impacting a number of the many elements of corporate governance – have an important objective to meaningfully reduce occurrences of fraud and failures in corporate reporting. Indeed, a primary thrust behind Sarbanes-Oxley and proposed changes to listing standards by the Listing Markets (e.g., new requirements pertaining to audit committee independence and financial expertise, auditor independence, ethical conduct and compliance) is the intent to drive and improve the reliability of corporate reporting.

The reforms create a far more rigorous environment for boards of directors and audit committees, who will no doubt seek to meet the requirements and conscientiously fulfil their new responsibilities. Hence, an understanding of the new requirements is essential.

However, leading boards and their audit committees will seek more than a state of compliance. They will strive for a distinctive level of effectiveness in their performance, looking for worthwhile viewpoints to help them achieve it.

Through this white paper, we invite boards and their audit committees to join us in exploring their changing roles in the era of corporate reform – particularly as these changes relate to corporate reporting. We will present information on the following areas:

- Major new provisions
- Required actions
- Key points to consider

The Need for Improvements in Corporate Reporting

The crisis in investor confidence revealed, among many issues, a loss of faith in corporate reporting. Boards of directors and their audit committees have many oversight responsibilities, but oversight of the integrity of company information reported to shareholders and other stakeholders is of paramount importance. In this paper we have chosen to focus on that critical dimension of corporate governance.

Corporate reporting will not improve by accident. Those involved in the process, a group we have designated the Corporate Reporting Supply Chain,[†] must commit to delivering quality corporate information to investors and other stakeholders.

As depicted below, the Corporate Reporting Supply Chain is the community responsible for producing, disseminating and using information related to publicly traded corporations.

Figure I-1: The Corporate Reporting Supply Chain^{}**



Each participant has unique responsibilities, linkages to others and an opportunity in this period of assessment and reform to help restore the public's trust in corporate reporting. Restoration of trust is in part dependent on those in the Corporate Reporting Supply Chain respecting and applying the values of transparency, accountability and integrity.

Transparency

A spirit of transparency means that companies willingly provide information needed by shareholders and other stakeholders to make decisions. Information is transparent when it provides the reader with a clear understanding of the company's financial condition, results of operations, cash flows and other aspects of its business.

[†] DiPiazza, Samuel A. Jr. and Eccles, Robert G., PricewaterhouseCoopers LLP. *Building Public Trust – The Future of Corporate Reporting*. New York: John Wiley & Sons, 2002.

^{**} *Standard Setters* refers to organisations that set accounting and auditing standards, as well as others in similar roles. *Market Regulators* include governmental agencies and other bodies that set and enforce rules relating to corporate reporting. *Enabling Technologies* contribute to the widespread distribution and use of reported information.

Accountability

Transparent information must be accompanied by a firm commitment to a culture of accountability among all participants in the Corporate Reporting Supply Chain. Each must take responsibility, in collaboration with all others, for carrying out a fundamental role in this chain.

Integrity

Transparency and accountability depend on people of integrity trying to “do the right thing,” not just what is expedient or even permissible. Without personal integrity as the foundation for reported information, there can be no public trust.

Strategies and Actions for Each Participant

In our first white paper in this series, *The Sarbanes-Oxley Act of 2002: Strategies for Meeting New Internal Control Reporting Challenges*, we examined the impact of Sarbanes-Oxley on company executives, and presented strategies and actions to help management understand and comply with new internal control reporting challenges.

Here, we continue to analyse the effects of Sarbanes-Oxley legislation, and consider the efforts by the SEC and the Listing Markets to implement, incorporate, refine or expand on Sarbanes-Oxley, with a focus on actions and strategies for boards of directors and audit committees. The next paper in the series will focus on the role of the external auditor in the Corporate Reporting Supply Chain.

1. Company Executives

Sarbanes-Oxley reaffirms that the CEO and CFO carry a primary responsibility for company reports filed with the SEC and institutes a requirement for them to report on the completeness and accuracy of information contained in the reports, as well as the effectiveness of underlying controls.

2. Boards of Directors and Audit Committees

Sarbanes-Oxley establishes new responsibilities for the audit committee in its capacity as a committee of a board of directors, including the appointment and compensation of the external auditor and oversight of the auditor’s work for the purpose of preparing or issuing an audit report or related work. It also establishes that the external auditor is to report directly to the audit committee.

The legislation requires the audit committee to pre-approve all services, regardless of their nature, that are provided by the external auditor. Moreover, each audit committee must comprise independent directors, as defined, and the company must disclose, among other things, whether at least one member of the committee meets the specified criteria of an “audit committee financial expert” and, if not, the reasons why.

3. External Auditors

An external auditor reports on the fairness of the presentation of a company's financial statements in accordance with generally accepted accounting principles. Sarbanes-Oxley reaffirms the necessity for the auditor to be independent of management, in fact and appearance, and expands the auditor's reporting responsibility to an attestation of the newly required management assertions on internal controls and procedures for financial reporting.

Alongside the legislation, the Listing Markets have proposed many changes to their corporate governance listing standards, the central themes of which are independence and empowerment of boards and their committees, ethical conduct and greater transparency and disclosures.

How This White Paper Can Help

This white paper considers several recent changes required of boards or their audit committees by Sarbanes-Oxley and the SEC, and other changes proposed as of January 2003 by the SEC and the Listing Markets. The proposals are subject to further SEC review and, in some instances, public comment. Accordingly, final provisions may differ from information presented in this paper.

By focusing on new and proposed changes, required actions and key points to consider throughout the process, this paper offers the opportunity to gain insight into how boards, largely through their audit committees, can increase the effectiveness of their own link in the Corporate Reporting Supply Chain. This serves to strengthen the entire chain – an important element of the foundation upon which public trust in corporate reporting is established.

Quick Reference Guides included in the back of this publication serve as a reminder of major points. It is important, however, to note that each board and audit committee should consider its own particular facts and circumstances in establishing its plans for compliance and identifying and implementing other actions intended to achieve a distinctive level of effectiveness in performance.

II. Boards of Directors Acting for the Shareholders

Broadly stated, leading boards of directors represent shareholders most effectively when they act to meet two objectives – being faithful to their oversight responsibilities, and advising or counselling management on important strategic, operating and financial decisions. New and proposed reforms undertaken in response to recent business scandals focus on the first objective.



The critical oversight role of a company's board and its audit committee in achieving an effective control environment was underscored a decade ago in the widely accepted COSO (Committee of Sponsoring Organizations of the Treadway Commission) internal control framework. According to COSO:¹

The control environment and “tone at the top” are influenced significantly by the entity's board of directors and audit committee. Factors include the board or audit committee's independence from management, experience and stature of its members, extent of its involvement and scrutiny of activities, and the appropriateness of its actions. Another factor is the degree to which difficult questions are raised and pursued with management regarding plans or performance. Interaction of the board or audit committee with internal and external auditors is another factor affecting the control environment.

The COSO framework describes the board's linkage to management as follows:²

Management is accountable to the board of directors..., which provides governance, guidance and oversight. By selecting management, the board has a major role in defining what it expects in integrity and ethical values, and can confirm its expectations through its oversight activities. Similarly, by reserving authority in certain key decisions, the board can play a role in high-level objective setting and strategic planning, and with the oversight that the board provides, the board is involved pervasively in internal control.

Provisions of Sarbanes-Oxley, SEC implementing rules and proposals made by the Listing Markets reach farther into boardrooms with new requirements for independence, structure and performance.

This section looks at some overarching changes affecting boards of directors. Requirements directed at audit committees are considered in Section III.

New and proposed requirements at the board level primarily focus on:

- A. Independence
- B. Independent Decisions
- C. Corporate Governance Guidelines
- D. Oversight of Ethical Conduct and Compliance
- E. Reporting of Additional Information to the Public

Many of these requirements can be viewed as strengthening aspects of the system by which all of a company's affairs are planned, managed and controlled – including its corporate reporting activities.



A. Independence

The common hallmark of corporate governance reforms proposed by the NYSE,³ NASDAQ⁴ and Amex⁵ is the emphasis placed on a board of directors having the capacity to exercise independent judgment while performing its responsibilities. For example, the NYSE Corporate Accountability and Listing Standards Committee, convened in 2002 to recommend ways to enhance the accountability, integrity and transparency of NYSE-listed companies, stated its belief that having a majority of independent directors would increase the quality of board oversight and lessen the possibility of damaging conflicts of interest.

All three Listing Markets propose that a board be composed of a majority of independent directors and would tighten the conditions for a member to be deemed independent. Those conditions focus primarily on whether or not a person has current or recent relationships with the company or its external auditor. The conditions for independence proposed by the individual Listing Markets are similar, but differ in some of the factors to be considered.

When adopted, these more stringent independence requirements can be expected to result in boards of public companies having a substantial representation of outside directors who do not have conflicts of interest (as defined or determined) with the company or its external auditor. The tightened conditions to be met for directors to qualify as independent are intended to further align boards with the interests of shareholders they represent.

Key Points to Consider

Independence

Assess the need to make changes in board membership.

- Change may be needed to meet new independence requirements.

Develop independence criteria and procedures for assessing and monitoring board member independence.

- Determine how relevant information will be obtained and evaluated.
- Apply independence criteria to existing members periodically and to potential members as they are considered.

Reach beyond satisfying independence requirements when evaluating the potential of new directors. A diverse mix of experiences and insights can help management identify and seize strategic opportunities and resolve critical problems.

Periodically reassess the relative balance between executive and independent directors, particularly when company circumstances or business objectives change.



B. Independent Decisions

Executive Sessions for Independent Directors

To empower independent directors to serve as a more effective crosscheck on management's actions, the Listing Markets have proposed that independent directors hold regularly scheduled executive sessions without management present (see Appendix A).

According to Korn/Ferry International's recent survey of directors from Fortune 1000 companies, 73% of the directors who participated said the board should hold regular executive sessions without the CEO. However, just 41% of the boards typically hold such sessions.⁶

Having periodic executive sessions without management enables independent board members to discuss important but sensitive issues meriting their attention. The push by the Listing Markets provides a further incentive to establish this practice when things are calm, rather than when there is a crisis.

Key Points to Consider

Executive Sessions

Directors' oversight role is enhanced by:

- Providing a forum for independent directors to speak openly and raise new issues.
- Allowing directors to operate without the constraints of any real or perceived influence or prescribed agendas.

Evaluate various leadership options for executive sessions, such as:

- Using an independent lead director, if there is one.
- Appointing a presiding director to formally lead the sessions.
- Using rotation of independent directors.

Use executive sessions to assess formal board meetings.

- Determine what worked and what should be changed and covered in future board meetings.
- Follow up with the CEO on the viewpoints raised.

Board Committee Standards and Processes

The Listing Markets' proposals call for additional use of independent board committees or directors, as well as certain other processes (see Appendix A). The NYSE proposal would require, for example, that a company establish nominating/corporate governance and compensation committees. If adopted, within one year following rule issuance, each of the committees must have at least one independent director and, within two years, all of each committee's directors must be independent. NASDAQ and Amex proposals call for board nominations to be approved by a nominating or similar committee of independent directors or by a majority of the independent directors, with certain exceptions.

While it is important for these committees to be composed wholly of independent directors exercising independent judgment, they should not work in a vacuum from management. They need to obtain and consider relevant information from, and the viewpoints of, senior management. For example, the nominating committee should obtain management's views about the desired capabilities and experiences to be represented on the board.

Although audit committees have recently received much adverse publicity, independent compensation committees are becoming the next hot seat in light of pressures from investors to better manage and, in some cases, reduce executive compensation packages. The NYSE proposal would also centre attention on compensation committees by having them review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance in light of those goals and objectives and set the CEO's compensation level based on that evaluation.

Key Points to Consider

Independent Committees

Establish an independent nominating/corporate governance committee or its equivalent to:

- Determine appropriate corporate governance practices that are responsive to the company's circumstances.
- Find qualified candidates for the board.
- Appoint the appropriate members to various committees.

Establish an independent compensation committee or its equivalent to:

- Review and approve corporate goals and objectives for the CEO and the related compensation package.
- Review and approve compensation packages for other executive officers, if required or desired.
- Consider whether or not the committee would benefit from using outside consultants.

Conduct board committee business in a manner to obtain and benefit from management's views and experience.



C. Corporate Governance Guidelines

The NYSE proposal would require each NYSE-listed company to adopt corporate governance guidelines that, at a minimum, must address each of the following:

- Director qualification standards relating to independence
- Director responsibilities such as expectations for attendance at meetings and advance reviews of materials
- Director access to management and independent advisers
- Director compensation, such as determinations of form and amount of compensation
- Director orientation and continuing education
- Management succession, including the process in the event of an emergency
- Annual performance evaluation of the board, including whether or not committees are functioning effectively

Some boards or board committees have already adopted charters or other guidelines covering a number of these areas as part of their best practices. However, practices vary widely. According to Korn/Ferry International's recent survey:

- 72% of Fortune 1000 boards have written guidelines on corporate governance.
- 63% of boards have a formal committee that reviews corporate governance processes and board operations.
- 37% of boards formally evaluate the entire board's performance on a regular basis.

While the percentage of boards with established practices in each of the foregoing areas has increased in recent years, the survey revealed that board practices have not kept pace with the opinions of most directors regarding good governance practices. For example, although most directors ranked having a formal management succession process as one of the three most important factors for good governance, only 51% indicated that their boards have an effective process.

Also, performance evaluation of individual committees and directors has not taken hold as a board practice. While the survey found that 73% of directors think that individual directors should be evaluated regularly by their peers regarding performance, only 21% of boards conduct such evaluations, and less than half of directors on those boards thought that the evaluations were effective.

Key Points to Consider

Corporate Governance Guidelines

If serving for a NYSE-listed company, consider the proposed rules, including the need to develop or implement formal corporate governance guidelines covering the specified matters.

Whether or not corporate guidelines are required, good reasons exist to have them:

- Guidelines can provide a road map for a proactive, focused oversight role and a barometer of progress.
- The development exercise can serve as a focal point for reassessing a board's scope, structure and priorities.
- A management succession plan and process, and annual board and committee performance reviews, are sound practices.

Review whether or not the appropriate committees are established, and whether there is clarity of responsibility and communications within and among committees and reporting to the board.

Work with the CEO to explore possible ways to strengthen the checks and balances between the CEO and board functions. Alternatives include:

- Having a lead director.
- Appointing a presiding director for certain board activities.
- Separating the Chairman and CEO positions.



D. Oversight of Ethical Conduct and Compliance

Codes of Business Conduct and Ethics

Integrity and a meaningful commitment to high ethical conduct are equally as important as compliance and risk management processes to an organisation.

Although it is well understood that ethics and integrity cannot be legislated, Sarbanes-Oxley and SEC rulemaking – and the Listing Markets through their proposed reforms – are establishing minimum standards or other guidelines pertaining to business and ethical conduct. In some instances, these standards or guidelines are intended to apply to directors in addition to officers and employees.

It is increasingly expected that a board will provide oversight of a company's ethical conduct. Notably, in the *Caremark* case, the Delaware Chancery Court also articulated the responsibility of boards of directors for overseeing ethics and compliance.⁷

A recently adopted SEC rule requires a company to disclose whether it has adopted a code of ethics for the CEO and senior financial officers, and if not, to explain why.⁸ The Listing Markets' proposed standards require member companies to adopt a code of business conduct and/or ethics, including compliance procedures, for directors, officers and employees.

The SEC rule provides specific objectives for a company's code of ethics (Figure II-1).

Figure II-1: Code of Ethics As Defined by the SEC

Code of Ethics As Defined by the SEC

Written standards reasonably designed to deter wrongdoing and to promote:

- Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships.
- Full, fair, accurate, timely and understandable disclosure in reports and documents that a company files with, or submits to, the SEC and in other public communications made by the company.
- Compliance with applicable governmental laws, rules and regulations.
- The prompt internal reporting of violations of the code to an appropriate person or persons identified in the code.
- Accountability for adherence to the code.

The SEC rule and Listing Markets' proposed standards establish requirements or expectations with respect to public disclosure of the code and performance of related compliance procedures (see subsection E). In addition, NYSE and NASDAQ have proposed that any waivers of the code for executive officers or directors may be made only by the board, or a board committee for NYSE.

As the NYSE committee noted, while no code can guarantee the ethical behaviour of individuals, a code can focus the board and management on areas of ethical risk, provide guidance to personnel to help them recognise and deal with ethical issues, provide mechanisms to report unethical conduct and help foster a culture of honesty and accountability.

Key Points to Consider

Oversight of Ethical Conduct and Compliance

Review the board's oversight practices in this area with reference to statutory and regulatory obligations – as well as shareholder interests and expectations.

Seek to have one or more board members who understand the sensitive ethical issues within the company's industry.

Oversee that the company is:

- Setting a strong "tone at the top" regarding corporate responsibility for ethical practices.
- Committed to business integrity.
- Living its values.
- Demonstrating that it has ethics and compliance processes in place.
- In compliance with the new code of conduct or ethics requirements.

Take a proactive approach to ethics:

- Ask questions about sensitive ethics situations.
- Follow through to confirm that the situations are resolved with fair-mindedness.
- Determine that the resolution reflects the accountability and integrity of the company and its employees, as well as compliance with legal requirements.
- Convey to company employees the board's commitment to having a strong ethical environment.

Establish a process for reviewing code waiver requests involving directors and executive officers, and others as may be desired.

Remember that perception is sometimes as important as fact and reality when dealing with ethical issues – to employees as well as outsiders.

Protection Against Improperly Influencing the Auditor

In October 2002, as directed by Sarbanes-Oxley §303, the SEC proposed to prohibit directors and officers – or anyone acting under their direction – from taking any action to fraudulently influence, coerce, manipulate or mislead the company’s external auditor for the purpose of rendering the financial statements materially misleading.⁹ Any of the following examples of conduct would be considered improper:

- Offering or paying bribes or other financial incentives, including offering future employment or contracts for non-audit services
- Providing an auditor with inaccurate or misleading legal analysis
- Threatening to cancel or cancelling existing non-audit or audit engagements if the auditor objects to the company’s accounting
- Seeking to have a partner removed from the engagement because he or she objects to the company’s accounting
- Blackmailing or making physical threats

The proposed rule supplements existing rules that address falsifying records, making false or misleading statements or omitting to make certain statements to auditors. When adopted, it would provide an additional means to sanction the improper conduct, regardless of whether the intended conduct succeeded in altering the audit or review.

A related SEC proposal – to require the audit committee to establish procedures for handling any complaints received by the company regarding accounting, internal accounting controls or auditing matters and any confidential submission by company employees about questionable accounting or auditing matters – is described in Section III of this publication.

Key Points to Consider

Protection Against Improperly Influencing the Auditor

When a board provides oversight in this area through its audit committee, it should understand the committee’s activities, be comfortable with their sufficiency and carefully consider findings reported to it.

Make inquiries of the audit committee to gain an understanding of the company’s protocols and practices regarding provision of objective, complete information to the auditor.

Consider looking beyond the deterrence rule to help foster a corporate culture that openly promotes and supports performance of comprehensive, rigorous external audits.



E. Reporting of Additional Information to the Public

New and proposed requirements call for a company to report specified information to the public with regard to its board of directors – primarily about the board’s independence and corporate governance guidelines and actions taken with regard to codes of conduct or ethics.

Board Composition and Governance

The NYSE proposal requires a company’s annual proxy statement to disclose the standards used by the board of directors in making independence determinations for its members. The stated intent is to provide investors with a means to assess the quality of a board’s independence.

The NYSE proposal also requires that a listed company publicly disclose on its website the corporate governance guidelines for its board of directors. Further, a listed company would need to disclose, in its proxy statement, which director presides over executive sessions without management present or the procedures used to select a presiding director for each session.

The Amex proposal requires a company to make timely public disclosure of board changes and vacancies.

Code of Ethics

A new SEC rule requires a company to disclose whether or not it has adopted a code of ethics that applies to the company’s CEO and senior financial officers and if not, to explain why.¹⁰ This disclosure is first required in annual reports for fiscal years ending on or after July 15, 2003.

A company will be required to make available to the public its code of ethics – or the portion of the code that applies to those officers – by filing it as an exhibit to its annual report, providing it on the company’s website or as otherwise set forth in the final rule. The Listing Markets propose requiring a company to make publicly available the code of business conduct and/or ethics for directors, officers and employees.

The new SEC rule also requires a company to disclose, within five business days, any changes to or waivers of the code of ethics applying to the company’s CEO or senior financial officers.¹¹ The NYSE and NASDAQ proposals would require disclosing any waiver for a director or executive officer.

Key Points to Consider

Reporting of Additional Information to the Public

Gain a thorough understanding of what must be reported and when.

Confirm adequate procedures are in place to develop reliable, complete information.

Review all proposed disclosures in coordination with management for reliability and completeness.

Use the company's website to convey the quality of corporate governance policies, as well as ethical conduct and values across the organisation. See that appropriate, up-to-date information about corporate governance guidelines and codes of conduct or ethics is maintained on the website.

Have procedures for the tracking and prompt reporting of code waivers involving directors, the CEO and other senior officers, as may be required or desired.

Surpassing the Mandate

Most current, new and proposed requirements involving boards of directors address their independence, structure and process. While adherence to the requirements is important, we believe that good corporate governance by a board of directors requires knowledgeable, diligent and committed directors who:

- Care about the company, its shareholders and other stakeholders
- Understand their oversight responsibilities and the opportunities to add value
- Are willing and have the ability to put in the needed time and effort
- Will work as a team to oversee how the company is being managed and discharge their responsibilities on behalf of shareholders

Boards of directors should consider implementing a formal corporate governance programme with comprehensive, pragmatic guidelines for an active oversight role and a strict, unalterable focus on ethical behaviour. Once the programme is in place, it should not be shelved. Directors need to be confident that management will do what is needed to support this oversight process.

Good corporate reporting requires that directors look beyond the numbers and consider the company's fundamentals. It requires them to consider whether the company's corporate reports are providing information that not only meets disclosure requirements, but is responsive to the principles of transparency, accountability and integrity.

A board should understand the business as a whole and should play a probing and active role in evaluating the strategies, processes and environment in which the business operates. Analytical frameworks for evaluating corporate performance are becoming more widespread and will likely be helpful. This wider, proactive perspective will lead to directors determining what information they should have for evaluating corporate performance, rather than relying solely on the information provided by management.

Directors should continue to move beyond viewing their role as primarily attending a monthly or quarterly event – the directors’ meeting. Even though they have a part-time oversight role, each should be thinking as a director representing shareholders about issues affecting the company and interacting with other directors, management, auditors and advisers as needed.

Sarbanes-Oxley, SEC implementing rules and, upon their adoption, new standards from the Listing Markets should be thought of as seeds of opportunity rather than as burdens requiring compliance. With effort, discernment and a commitment to excel, a board of directors can leverage these changes to help make its role more valuable to the company and its shareholders.



III. The Special Role of Audit Committees

If audit committees feel a spotlight directed toward them today, it is understandable. Audit committees of many of the companies that disclosed questionable accounting practices or significant financial reporting problems over the past year have been criticised. As often happens in these types of circumstances, practices of other audit committees then get questioned.

Some, but not all of the criticism is deserved. Many audit committees have, in the past, effectively discharged their responsibilities on behalf of the full board and shareholders – and continue to do so. But the overall framework for audit committee performance needs some adjustment.

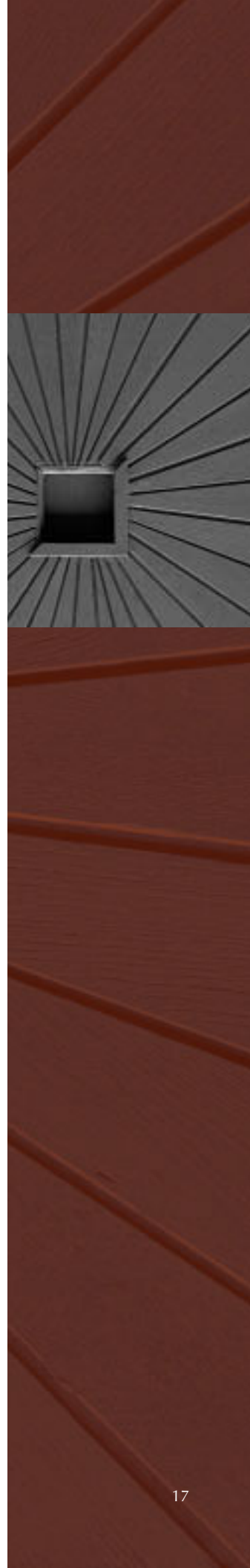
A platform for change now exists in the form of Sarbanes-Oxley, SEC implementing rules and more rigorous listing standards in this area proposed by the NYSE, Amex and NASDAQ.

This paper focuses on the audit committee as a critical part of the board of directors in the Corporate Reporting Supply Chain. In this section, we examine five key aspects of an audit committee's structure and the activities affecting its pivotal role:



- A. Authorities and Composition
- B. Oversight Responsibilities
- C. Reporting Responsibilities
- D. Relationships with Others
- E. Evaluation and Education

For each aspect, new and proposed corporate reform requirements are summarised. In addition, considerations and opportunities are offered for enhancing the effectiveness of audit committees.





A. Authorities and Composition

As directed by Sarbanes-Oxley §301, the SEC in January 2003 issued a proposed rule pertaining to standards for listed company audit committees.¹² The proposed rule adopts Sarbanes-Oxley's definition of an "audit committee," as being:

- "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
- If no such committee exists..., the entire board of directors of the issuer."

The proposed rule would direct national securities exchanges and associations to develop standards that would prohibit their listing securities of any company not in compliance with the audit committee requirements mandated by Sarbanes-Oxley (allowing for specified exceptions).¹³ When effective, those requirements would impose eligibility standards and other duties or obligations on audit committees and grant them authorities to take certain actions, as follows:

1. Have only members who are independent according to specified criteria.
2. Be directly responsible for appointing, compensating, retaining and overseeing the work of the external auditor engaged to prepare or issue an audit report or related work, or perform other audit, review or attest services for the company.
3. Establish procedures for handling complaints regarding accounting, internal accounting controls or auditing matters and the confidential, anonymous submission by company employees of concerns regarding questionable accounting or auditing matters.
4. Have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.
5. Have the authority to determine appropriate funding needed from the company to pay the company's external auditor for audit, review or attest services and any advisers employed by the audit committee.

Under the SEC's proposed rule, national securities exchanges and associations would need to, among other requirements: (1) provide the SEC with their proposed listing standards or amendments that comply with the SEC's final rule no later than 60 days after that rule is published in the Federal Register and (2) have their standards operative no later than one year after the SEC final rule is published. Sarbanes-Oxley requires the SEC's new rule to become effective by April 26, 2003. This rulemaking process is referred to in this subsection as "SEC and Listing Markets' actions."

An entire board of directors that constitutes the audit committee would be subject to all the requirements directed to audit committees, including the need for all members to be independent (allowing for specified exceptions).

The exchanges and associations are not precluded from adopting additional standards beyond those prescribed in the SEC final rule if they are consistent with that rule. Earlier in 2002, the NYSE, Amex and NASDAQ developed for SEC review and public comment, proposed corporate governance listing standards covering audit committees and other matters. (Appendix A has a summary.) In light of the SEC's rulemaking, parts of these proposals covering audit committees may be revised.

When effective, new Sarbanes-Oxley requirements would strengthen the audit committee's role in several ways:

- Its direct responsibility for engaging the external auditor and approving and paying for external auditor services would reduce the risk that the auditor may view its client as management and possibly compromise the audit.
- Its ability to hire and compensate special advisers provides a direct avenue to engage qualified people to obtain objective counsel on potentially troublesome matters – and thus have a stronger base of information upon which determinations may be made in the best interests of shareholders.

Each of the Sarbanes-Oxley requirements is considered below.

Requirement 1 – Independence

As mandated by Sarbanes-Oxley, each audit committee member must be a member of the company's board of directors and independent as defined (with limited exceptions provided).

The proposed SEC rule would require that, to be considered independent for the audit committee, a person may not:¹⁴

- Accept, directly or indirectly, any consulting, advisory or other compensatory fee from the company other than in his or her capacity as a member of the audit committee, board of directors or other board committee¹⁵
- Be an "affiliated person" of the company or any subsidiary thereof¹⁶

In addition to SEC considerations, Listing Markets' current standards and proposed changes incorporate other independence guidelines and criteria (see Appendix A). SEC and Listing Markets' actions would make provisions of those proposals effective, possibly after some revision.

Key Points to Consider

Independence

Develop procedures for assessing and monitoring audit committee independence.

- Coordinate with the board or nominating committee to develop procedures for applying the more rigorous independence criteria.
- Apply criteria to existing members periodically, and to potential members during the evaluation or recruiting period.

Recognise that an audit committee's independence, in both fact and appearance, is significant to investor confidence. Independence in appearance demands that a reasonable person with knowledge of the interests of an audit committee member would conclude that the member is able to make independent judgments.

Requirement 2 – Financial Expertise

The SEC has issued a final rule¹⁷ requiring disclosure in periodic reports as to whether or not at least one “audit committee financial expert” – according to the board – is serving on its audit committee. The rule requires such a person to have all of the following attributes:

- An understanding of generally accepted accounting principles and financial statements
- The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves
- Experience preparing, auditing, analysing or evaluating financial statements presenting a breadth and level of complexity of accounting issues generally comparable to those that can be reasonably expected to be raised by the company's financial statements, or experience actively supervising one or more persons engaged in such activities
- An understanding of internal controls for financial reporting
- An understanding of audit committee functions

The rule further requires the person to have acquired the attributes through one or more of the following:

- Education and experience as a principal financial or accounting officer, controller, public accountant or auditor, or experience in one or more positions involving the performance of similar functions
- Experience actively supervising a person performing in one of the above capacities
- Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements
- Other relevant experience

Companies must comply with the audit committee financial expert disclosure requirements in their annual reports for fiscal years ending on or after July 15, 2003 (December 15, 2003, for small business issuers).

Listing Markets' current standards and proposals also require that an audit committee member or members meet specified criteria generally pertaining to having financial "literacy," "sophistication," or "accounting or related financial management expertise."

Key Points to Consider

Financial Expertise

Assess the need for an "audit committee financial expert."

- Coordinate with the board or nominating committee, particularly as to any planned or imminent rotations of directors among committees.
- Consider the audit committee's current makeup of skills and experiences, including financial expertise.
- Determine the attributes of financial expertise most desirable to have represented on the committee. Having more than one person with such expertise may improve the ability to provide effective oversight of the financial reporting process, financial statements and underlying internal controls.

When needed, recruit audit committee members.

- Ascertain that candidates are willing to commit the requisite time.
- See that safeguards, such as appropriate indemnifications and adequate D&O insurance coverage, are in place.

Requirement 3 – Arrangements with the External Auditor

As mandated by Sarbanes-Oxley §301, the SEC¹⁸ and Listing Markets' actions would make the audit committee directly responsible for appointing, compensating, retaining and overseeing the work of the external auditor engaged for the purpose of preparing or issuing an audit report or related work or performing other audit, review or attest services for the company.¹⁹ This responsibility includes resolving disagreements between management and the auditor regarding financial reporting. Sarbanes-Oxley and the SEC's proposed rule would also require the external auditor to report directly to the audit committee.

Pre-Approving Services Provided by the External Auditor

A related final rule by the SEC points to the audit committee's important oversight responsibilities regarding external auditor independence. It requires enhanced procedures intended to minimize any risks that the external auditor's independence may become impaired.²⁰ In particular, the final rule requires a company's audit committee to pre-approve all allowable services to be provided by its external auditor.²¹

The committee may establish policies and procedures for pre-approval that would operate in lieu of pre-approval on an engagement-by-engagement basis, provided that (1) the policies and procedures are detailed as to the particular service and do not delegate the pre-approval process to management and (2) the audit committee is informed of each service.

The SEC rule outlines three principles of independence that the SEC followed in developing its new rule, violations of which would impair the auditor's independence:

- An auditor cannot function in the role of management.
- An auditor cannot audit its own work.
- An auditor cannot serve in an advocacy role for its client.

The rule identifies the following types of non-audit services that are generally prohibited:

- Bookkeeping or other services related to the company's accounting records or financial statements *
- Financial information systems design and implementation *
- Appraisal or valuation services, fairness opinions or contribution-in-kind reports *
- Actuarial services *
- Internal audit outsourcing services *
- Management functions or human resources
- Broker or dealer, investment adviser or investment banking services
- Legal services
- Expert services unrelated to the audit
- Any other service that the Public Company Accounting Oversight Board determines, by regulation, is impermissible

* The external auditor may perform this type of service, if pre-approved by the audit committee, only where it is reasonable to conclude that the results of the particular service will not be subject to audit procedures during the auditor's audit of the company's financial statements.

The SEC rule provides descriptions of these services, which will help the audit committee in making pre-approval decisions.

The SEC has stated that, in general, an external auditor can continue to provide tax services such as compliance, planning and advice to an audit client, subject to audit committee pre-approval. However, the SEC specifically stated that the external auditor is prohibited from representing an audit client before a tax court, district court or federal court of claims. Further, the SEC encourages audit committees to carefully scrutinise any proposed engagement of the auditor pertaining to possibly unsupportable "tax avoidance" transactions it may recommend.

The pre-approval requirement will be effective May 6, 2003. Accordingly, the audit committee is required to pre-approve audit and non-audit services provided on or after that date. However, the rule permits the external auditor to render services on or after May 6, 2003, without pre-approval if they are rendered pursuant to contracts existing on May 6, 2003, and completed before May 6, 2004.

Key Points to Consider

Arrangements with the External Auditor

Establish a decision process for appointing and retaining an external auditor.

- Acknowledge the importance of the responsibility.
- Make certain the process is comprehensive.

Communicate clear expectations to both the accounting firm and engagement team regarding the:

- Need to meet high performance standards.
- Conduct of the audit in order to raise the quality “bar.”

Apply the expanded rules for external auditor independence.

- Coordinate with management and the auditor to monitor independence compliance.
- Consider establishing a policy – with reference to regulatory or other requirements – related to hiring the external auditor’s employees.

Establish appropriate channels and procedures for ongoing communications with the external auditor.

- Obtain and review required communications from the external auditor.

Establish policies and practices for pre-approving audit and non-audit services.

- Tailor to fit the company’s circumstances and make sure they are in the shareholders’ interests.
- Guard against pre-approval determinations becoming routine.

Review external auditor’s safeguards to protect its independence and enhance audit quality, remembering that integrity is critical. Safeguards can include:

- Involving a second partner in the review of important accounting and auditing judgments.
- Protocols for resolving professional differences of opinion.
- Involvement and authority of the firm’s national office technical specialists.
- Quality control reviews of partners’ work.
- The audit firm’s policies for compensating and rewarding partners.

Evaluate results of peer reviews and other inspections of the external auditor to be undertaken by the Public Company Accounting Oversight Board.

Requirement 4 – Complaint Resolution and Special Investigations

As mandated by Sarbanes-Oxley, the SEC and Listing Markets’ actions would require an audit committee to establish procedures for:

- The receipt, retention and disposition of complaints received by the company regarding accounting, internal accounting controls or auditing matters
- Handling the confidential, anonymous submission by company employees of concerns regarding questionable accounting or auditing matters²²

The SEC has not proposed to mandate specific procedures that the committee must establish, wanting to provide flexibility for varied circumstances.

An audit committee’s effectiveness is dependent, to an important extent, on the nature, quality, clarity, timeliness and completeness of information it receives from management about the



company's financial reporting process. However, management may not have the appropriate incentives to self-report all questionable practices. In addition, a company employee or other individual may be reticent to report concerns regarding questionable accounting, reporting or other matters for fear of reprisal.

When effective, the rule will require a company to establish procedures for employees and others to communicate any of these types of concerns. Importantly, the audit committee should also determine that the company's operating culture – including its own and management's leadership – encourages and supports open communications about any employee concerns in this area.

Requirement 5 – Use of Independent Counsel and Other Advisers If Needed

As mandated by Sarbanes-Oxley, the SEC and Listing Markets' actions would also enable the audit committee's use of the authority granted to it to engage outside advisers, including counsel, as it determines necessary to carry out its duties.²³

To be effective, an audit committee should have a complement of appropriate experiences, skills, knowledge and expertise, as well as access to other resources. Audit committees should not be expected to seek outside counsel on most matters or, conversely, to take their own counsel on every complex or significant matter requiring their judgment.

An audit committee should have confidence in the abilities and integrity of management, internal counsel, external and internal auditors and other advisers to the company and expect to be comfortable with the quality of financial, legal and other analysis and advice they provide. When this is not the case, corrective or mitigating actions should be taken – one of which may be to seek input or counsel from other parties.

The separate analyses, advice and other services from independent advisers may be beneficial or even essential in unusual circumstances such as the following, where:

- Issues involving management or other circumstances require a special investigation and possibly an expert opinion. Expert opinions may be used, for example, for advocating a company's interests in litigation, a regulatory or administrative proceeding or other outside investigation.
- Disagreement exists between major parties leading, advising or otherwise serving the company or its shareholders.

In these circumstances, the audit committee can independently engage outside advisers who can draw on their experiences and expertise to recommend appropriate actions. Being judicious, not operating under restraint, should be the guiding principle for committees in considering the use of independent advisers.

Some companies are finding it beneficial to establish a policy covering the use of independent advisers, including protocols for evaluating whether particular circumstances merit their use.

Requirement 6 – Funding for the External Auditor and Advisers

Finally, as mandated by Sarbanes-Oxley, the SEC and Listing Markets' actions would require the company to provide appropriate funding, as determined by the audit committee, for payment of compensation:

- To the external auditor for purposes of rendering or issuing an audit report or related work, or other audit, review or attest services for the company
- To any advisers employed by the committee

This funding authorisation would reinforce the audit committee's authority to appoint and compensate the outside auditor and to engage independent advisers. The ability to obtain funding should help the committee and outside advisers perform their respective duties objectively, particularly in any instances involving resolution of disagreements or other issues with management.

B. Oversight Responsibilities



The Audit Committee Charter and Priorities

The expectations of Congress, the SEC and the Listing Markets – as well as shareholders – are that the audit committee will assume and perform meaningful oversight responsibilities. The audit committee is perceived to be the shareholder's watchdog regarding the integrity of a company's corporate reporting.

In particular, proposed NYSE standards call for an audit committee charter that would set forth specific responsibilities and duties involved in assisting board oversight with regard to the:

- Integrity of the company's financial statements
- Company's compliance with legal and regulatory requirements
- Independent auditor's qualifications and independence
- Performance of the company's internal audit function and independent auditor

Similarly, Amex and NASDAQ propose to add expanded responsibilities for audit committees by generally aligning their requirements with corresponding Sarbanes-Oxley provisions.

Key Points to Consider

Audit Committee Charter and Priorities

Recognise that an audit committee serves as the eyes, ears and voice of the board and shareholders.

Establish a framework of oversight activities for the audit committee that are appropriate to the company's circumstances, by such steps as:

- Reassessing the current charter and revising it as needed to address new requirements, company circumstances and changing expectations of the board and shareholders.
- Incorporating in the charter required responsibilities and additional oversight activities the committee expects to perform.
 - Keep a principal focus on the company's periodic SEC reports containing financial statements and other information, financial reporting and disclosure controls, as well as internal and external audit activities.
 - Consider the desired nature and extent of additional oversight activities regarding, among others:
 - Other SEC and regulatory filings
 - Other communications to the public, such as press releases covering financial matters
 - Legal, regulatory and tax matters
 - Enterprise-wide risk management
 - Business conduct and ethics
 - Special investigations
 - Performance evaluations
 - Consider the scope of other oversight activities in place at the board level or in other board committees, to help confirm that the charter is appropriate and complementary.
- Reviewing the proposed charter with the full board of directors, management, counsel, and external and internal auditors.

Post the approved audit committee charter to the company's website – to provide shareholders and others an opportunity to understand the nature of the adopted oversight practices.

The audit committee's direct responsibility for arrangements with the external auditor is discussed in subsection A. Oversight responsibilities with regard to other aspects of corporate reporting and internal controls are considered next.

Responsibility 1 – Oversight for Corporate Reporting

A traditional and continuing key responsibility of the audit committee is to provide oversight regarding a company's financial reporting and underlying controls. This is affirmed by regulators who look to the audit committee to provide such oversight.

For example, SEC rules and U.S. auditing standards require the external auditor to communicate specified information to the audit committee regarding the financial statements and internal controls.²⁴ The SEC also requires the audit committee to disclose whether or not it has discussed the financial statements with management and specified matters with the auditor. The SEC further requires the committee to disclose whether it has recommended to the board that the audited financial statements be included in the company's annual report filed with the SEC.²⁵ Similarly, the NYSE proposal calls for the audit committee to assist the board in overseeing the integrity of the company's financial statements, as well as to discuss with senior management the company's guidelines and policies with respect to risk assessment and risk management.

Further, two Sarbanes-Oxley requirements will have a continuing impact on corporate reporting: §302 CEO and CFO certifications, and §404 reporting on internal controls over financial reporting (the SEC has not yet issued a final rule for the latter). Companies are now required to report on the effectiveness of specified internal controls – joining large banking companies that have been subject, for the past decade, to internal control reporting under the FDIC Improvement Act.

Our first white paper in this series, entitled *The Sarbanes-Oxley Act of 2002: Strategies for Meeting New Internal Control Reporting Challenges*, examines the SEC implementing rules for §302 certifications and §404 reporting. It presents leading strategies and actions to help management and others such as audit committees address the new reporting challenges.

Key Points to Consider

Oversight for Corporate Reporting

Be engaged in the issues, understand them and form independent judgments – guard against using a “checklist” process.

Determine which elements of corporate reporting – beyond quarterly and annual financial statements and internal controls over financial reporting – are subject to audit committee oversight.

For financial reports:

- Review for clarity and responsiveness to expanded disclosure requirements.
- Understand the external auditor's viewpoints about critical accounting policies and their effect on the financial statements.
- Understand any other significant issues affecting the quality of earnings.
- Ascertain whether there are any unresolved concerns or inquiries on the part of regulators about financial reporting policies or practices.

For internal controls over financial reporting:

- Review the process management plans to use to evaluate and report on the effectiveness of internal controls over financial reporting as will be required under Sarbanes-Oxley §404.
- Ascertain whether any material weaknesses or other significant deficiencies, or any fraud involving anyone with a significant role in these controls, has been identified.
- Review management's remediation for those deficiencies and frauds, including their possible impact on financial and internal control reports.

Review the process used by management in complying with other internal control reporting requirements and in evaluating the effectiveness of specified controls – including CEO/CFO certifications on disclosure controls and procedures required by Sarbanes-Oxley §302.

Discuss with management their philosophy and practices with respect to disclosing company-related information beyond that required in periodic reports – underscoring the importance of providing willingly to shareholders, other stakeholders and prospective investors salient information needed to make decisions.



Responsibility 2 – Oversight for the Internal Audit Function

NYSE proposed standards call for a listed company to have “an internal audit function” or at least “an appropriate control process for reviewing and approving its internal transactions and accounting.” The proposal would allow a company to outsource the internal audit function to a firm other than its external auditor, but states that the audit committee should assist with board oversight of the performance of the internal audit function.

In many companies, the ability of the audit committee and internal auditors to work well together significantly impacts how effectively the committee fulfils its responsibility to the board of directors and shareholders. The audit committee may want to arrange for the internal auditors to review and evaluate the effectiveness of the company’s system of internal control supporting corporate reporting, operations and compliance objectives. Internal auditing may also be used as a source of information to the audit committee on frauds and irregularities.

Key Points to Consider

Oversight for the Internal Audit Function

Oversee the internal audit function’s major responsibilities, scope and staffing plans, aligning its work with the needs of the committee and management.

- Consider, for example, whether or not auditors are expected to conduct a broad, systematic review of the company’s risk-management processes and controls.

Consider reporting arrangements for the internal audit function, emphasizing independence and objectivity.

Provide the internal audit function regular access to the audit committee and executive management, arranging for the internal audit director or the equivalent to:

- Attend audit committee meetings.
- Meet privately with the audit committee at regular intervals.

Check that internal audit groups have sufficient qualified resources to perform the agreed upon work.

Confirm that internal audit activities are being carried out in accordance with professional standards for the practice of internal auditing.

Review internal audit’s significant findings and recommendations and monitor remediation activities.

Enhance internal audit’s independence by consulting with executive management on the appointment and ongoing performance evaluation of the internal audit director.

Responsibility 3 – Oversight for Related Party Transactions

The Amex proposal would require the audit committee, or a comparable body having only independent directors, to provide oversight as to related party transactions. NASDAQ would require such a body to approve all related party transactions.

The audit committee or another independent body of the board should consider developing guidelines or policies for reviewing and making informed decisions about related party transactions, with input from legal counsel as may be required or desired.

In addition, given the general sensitivity surrounding related party transactions, audit committees may want to confirm that management has appropriate policies and practices in place covering management's identification and review of related party transactions.

C. Reporting Responsibilities



New and proposed rules call for the audit committee to report specified information to the full board of directors and to the public.

Reporting to the Board of Directors

The NYSE has proposed that the audit committee report regularly to the board of directors any issues that arise with respect to the:

- Quality or integrity of the company's financial statements
- Company's compliance with legal or regulatory requirements
- Performance and independence of the company's external auditors
- Performance of the internal audit function

This type of reporting is already provided in many companies. One common approach is for the audit committee chair to brief the full board of directors regarding each audit committee meeting or other significant activities undertaken. This enables board members who are not on the committee to ask questions and express their own viewpoints about any matters covered.

The audit committee chair or another member should also interact with other board committees and possibly share resources in considering joint issues. Joint meetings may be helpful on occasion.

Reporting to the Public

New and proposed SEC rules call for a company to publicly disclose specified information of or about its audit committee. The disclosures primarily involve information about the committee's charter and its members' independence and financial expertise, about its discussions of the financial statements with management and the external auditor, and about the external auditor's services and fees.

Final Rules

New SEC rules will require a company to disclose in its annual reports to the SEC or its proxy statement, the name of any audit committee financial expert and whether or not that member is independent; if no member is such an expert, the company will need to explain why not.²⁶

The SEC will also require disclosures (modifying and expanding current rules) about external auditor services, including, among others:²⁷

- The audit committee's policies and procedures for pre-approving external auditor services
- Fees paid to the auditor for audit services, audit-related services, tax services and other services
- The nature of all services other than "audit services"

A company subject to the proxy rules of Section 14 of the Exchange Act is currently required to disclose, if action is to be taken with respect to the election of directors, the following types of information:²⁸

- Whether or not the company has a standing audit committee
- Whether or not all audit committee members are "independent" as defined in the applicable listing standards, and certain additional information regarding any member who is not
- Whether or not its board of directors has adopted a written charter for the audit committee and, if so, include a copy of the charter as an appendix to the proxy statement at least once every three years and for the year when the charter is revised
- Additional information about its audit committee, such as functions performed, the number of meetings held and names of committee members
- A report of its audit committee that states whether or not the committee:
 - Has reviewed and discussed the audited financial statements with management
 - Has discussed certain matters with the external auditor and received from the auditor certain disclosures regarding its independence
 - Based on that review and discussion, has recommended to the board of directors that the audited financial statements be included in the company's annual report for filing with the SEC

Proposed Rule

The SEC's proposed rule relating to listed company audit committees provides certain exemptions for some types of specialised entities and other specific circumstances. The proposal would require such an entity to disclose its reliance on an exemption and its assessment of whether or not, and

how, such reliance would materially adversely affect the ability of its audit committee to act independently and satisfy the other requirements of the proposed rule. Those disclosures would be required in, or be incorporated by reference into, annual reports filed with the SEC and in proxy or information statements for shareholders' meetings at which directors would be elected.²⁹

Key Points to Consider

Reporting to the Board of Directors and the Public

Establish procedures for providing meaningful and focused updates to the board and other board committees after each audit committee meeting, and at intervening periods, when necessary.

Understand required disclosures to the public about or from the audit committee, and confirm that procedures are in place to develop reliable and complete information.

Review proposed disclosures with the board, management, counsel and external auditors, looking to confirm their accuracy and completeness.



D. Relationships with Others

Relationships with the External Auditor

In view of the explicit requirement that the external auditor must report to the audit committee, both parties are rethinking how best to have strong and effective relationships with each other. The relationships should be particularly vital, open and mutually supportive.

Mutual Support and Respect

The auditor's support of the audit committee is intended to enable the latter to effectively discharge its oversight responsibilities on behalf of the shareholders. In turn, the audit committee's support of the auditor enhances the auditor's effectiveness and helps preserve its independence from management.

Furthermore, the relationship between the committee chair and the lead audit partner should set the overall "tone" or expectations for others. These leaders should have working styles that emphasise "mutual engagement" over strict form-based adherence to draw lines of responsibility. The shared objective of both – to assure that financial information reported by management is credible and reliable – provides the basis for this engagement.



Executive Sessions

The NYSE proposal would require the audit committee to meet privately with external auditor representatives, which is also a best practice with a number of companies. These sessions are essential to cover customary topics, and help to advance the relationship and build trust between parties. Productive executive sessions require effort and good faith by both sides. The auditors should be willing to talk candidly to the committee; committee members should make clear that they seek and need the auditor's views.

Appraisal of Performance

The final and essential step for an audit committee and external auditor in working together effectively is to produce a report card on the external audit itself. This report should be an honest appraisal by both the committee and the auditor of:

- How well the auditor did
- How well the audit committee did
- What improvements need to happen going forward to achieve their mutual objectives

The performance appraisal should make the audit process more effective. It is structured to create openness and straight talk between the audit committee and auditor. In turn, this fosters better and faster awareness of issues, and brings resources and expertise needed to reach timely and appropriate decisions about corporate reporting.

Relationships with the Internal Auditor

A good working relationship with the internal auditor can assist the committee in fulfilling its responsibility to the board of directors and shareholders. The effective discharge of internal audit responsibilities requires an ongoing relationship with the audit committee. The relationship between the audit committee chair and the internal audit executive is especially important. There, communication should be ongoing.

Relationships with Company Management

The audit committee should interact extensively with company management to obtain information on various matters and consider management's recommendations and reports. This is necessary for the audit committee to make informed, sound judgments in exercising its oversight role. Thus, the committee should have unlimited access to management.

A dialogue with the CFO, other financial officers, the chief risk officer, general counsel, chief compliance officer, chief information officer and others helps the committee understand and probe the types of risks affecting the company and how they are being managed.

In the past, many boards and committees have relied primarily on top management to identify and assess key risks. Today, boards should review whether management's policies and controls are robust and tailored to the company's key risks. Dialogue with management should include questions about the use of standards and practices such as COSO and industry guidelines to measure the effectiveness of the company's policies and controls in dealing with financial, operational and compliance risks.



E. Evaluation and Education

Evaluating the Audit Committee's Performance

Improvements in most business operations are realised through measurements and other evaluative techniques, and the audit committee's performance is no exception.

NYSE proposed standards for its listed companies would require an annual performance evaluation of the audit committee. Best practices for boards of directors and their audit committees have also incorporated some form of evaluation or self-assessment process. However, the frequency and comprehensiveness of evaluations vary substantially among audit committees.

Orientation and Continuing Education

Particular consideration should be paid to the orientation of new audit committee members, who should be provided the orientation needed to meet their responsibilities. Existing members and company management should help new members understand the company's values, philosophy, mission, strategic plans, business plans, operations and financial reporting in dealing with key issues throughout the year.

Audit committee effectiveness is often enhanced when members participate in continuing education programmes designed to increase their knowledge of best practices and matters regarding risk management, financial reporting, accounting, auditing and related areas.

Appendix B lists additional publications by PricewaterhouseCoopers that address important considerations for corporate governance and audit committee activities.

Key Points to Consider

Evaluating Performance

Directors serving NYSE-listed companies should be aware of the proposal that, if approved, will require audit committees to undertake annual self-assessments.

In performing evaluations, seek feedback about the committee's activities and performance from the internal and external auditors and from management.

Consider benefits achievable through the use of a third-party facilitator.

Consider the use of self-evaluation tools that can be tailored to the particular committee's objectives, structure and setting. For example, PricewaterhouseCoopers' publication, *Audit Committee Effectiveness – What Works Best*, includes a self-assessment guide for audit committees.



IV. Issues for Non-U.S. Companies

In adopting the Sarbanes-Oxley Act, the U.S. Congress made very little distinction between domestic issuers and foreign private issuers of securities registered in the U.S. (foreign companies). While the SEC has the authority to exempt foreign companies from Sarbanes-Oxley requirements, such exemptions are expected to be limited generally to those situations where a conflict exists between Sarbanes-Oxley requirements and another country's laws or regulations.

Regulatory Deliberations in Process

In the past, most U.S. securities exchanges and associations made accommodations for these foreign companies in their listing standards – accommodations that would continue in large part under their recently proposed rules. For example, the NYSE's 2002 proposal would require only that foreign companies disclose any significant ways in which their corporate governance practices differ from the requirements under its listing standards.

However, in January 2003, the SEC proposed a new rule directing U.S. national securities exchanges and associations that, as a condition for a company's securities being listed, the company must comply with audit committee-related requirements of the SEC. The SEC proposes to apply this rule to foreign as well as U.S. companies, asserting that maintaining effective oversight over the financial reporting process is relevant for listed securities of any company.³⁰ It notes that many foreign companies already maintain audit committees, and that the global trend appears to be toward establishing such committees. If this rule is adopted, the major variable then becomes the extent to which the SEC will provide exceptions or other variations for foreign companies.

For many foreign companies already committed to high standards of corporate governance, applying the SEC's standards for audit committees will not necessarily result in any fundamental change to their policy objectives in this area. However, it could give rise to structural or procedural changes and to reallocations or redefinitions of governance responsibilities, the undertaking of which may require considerable effort. For other affected foreign companies that do not currently have audit or similar committees, the proposals can be expected to have even more impact.

Some Consideration for Differing Laws and Practices

A number of foreign companies, trade groups and other interested parties have objected to the SEC's push for having only limited exceptions for foreign companies – arguing that these rules, as well as other aspects of the Sarbanes-Oxley Act, should exempt foreign companies from requirements that would conflict with laws and regulations in their countries.

The SEC appears to be sensitive to these conflicts. In conjunction with its recent proposed rules, the SEC has requested comments on areas of conflict between its proposals and the laws and regulations of the affected foreign companies' home countries. It is also continuing to explore possible solutions with foreign securities regulators and other bodies.

While not proposing wholesale relief for foreign companies, the SEC is tending to provide limited accommodations relating to a specific conflict. For example, it is proposing special rules or exemptions to recognise certain cultural or legal differences such as:³¹

- The requirement, common in some countries, that non-management employees who would not be viewed as “independent,” serve on the supervisory board or audit committee
- The use of two-tier boards, with one tier designated as the management board and the other designated as the supervisory or non-management board
- Government ownership of significant shareholdings in some foreign companies entitling the government to exercise rights relating to those companies
- The use of boards of auditors (or a similar body) or groups of statutory auditors

The Challenge

This section has touched on some issues that exist for foreign companies with securities registered on U.S. markets and of deliberations now in process. We encourage directors and management of affected foreign companies to obtain specific information about these discussions and proposals and consider providing feedback. If accommodations are to be made, the SEC will need to understand the extent of differences in laws and practices, their resulting impacts, and ideas for reasonably accommodating the spirit of various Sarbanes-Oxley provisions where the application of a detailed rule could be illegal or cost prohibitive in the home country.

Our firm will be providing additional information as the deliberations continue, including suggestions for coping with cultural and legal differences.

V. Conclusion

If history teaches us anything, it is that patterns repeat. The cycle of scandal, reaction and fallout is all too familiar. But events – even cataclysmic ones – lead to change, often for the better.

For our entire system of corporate governance to improve, boards of directors and their audit committees must be among the chief architects of reform in their dual role as protector of shareholder interests and trusted adviser to management.

It is a pivotal role, coming at a time when investors are seeking a clear voice of representation.

Board and audit committee members will need to focus more of their attention on appropriate checks and balances. They will have to take a hard look at their composition. Members must ensure that management is creating and sustaining value, even while they are being more proactive in challenging management's assumptions and recommendations.

Independent oversight of corporate reporting is a core element of this reform. To that end, we urge board and audit committee members to assert their oversight roles.

Vigilance is not an option – it is a must. Sarbanes-Oxley legislation and proposed reforms by the major U.S. securities exchanges and associations demand meaningful responses. Inherent in the movement toward reform is not only the need to comply, but also the opportunity to achieve a greater level of effectiveness.

As linked members of the Corporate Reporting Supply Chain, boards and their audit committees have a unique opportunity to oversee the reliability of corporate information. Consistently applying the principles of *transparency, accountability and integrity* to corporate reporting will provide solid evidence of a commitment to reform, as corporations and other institutions seek to rebuild a relationship of trust with the public.

Appendix A:

Proposals by NYSE, Amex and NASDAQ

The New York Stock Exchange (NYSE),³² The American Stock Exchange (Amex)³³ and The NASDAQ Stock Market (NASDAQ)³⁴ (collectively referred to as "Listing Markets") each approved, in 2002 for SEC review, a series of proposed corporate governance reforms to its listing standards. These reforms generally pertain to the independence, authorities and responsibilities of member companies' boards of directors and committees, as well as certain disclosure matters.

As directed by Sarbanes-Oxley §301, the SEC issued in January 2003 a proposed rule pertaining to standards for listed company audit committees.³⁵ The rule would require U.S. national securities exchanges and national securities associations to conform their securities listing standards to the SEC rule, as finalised, with regard to audit committees.

Under the SEC's proposed rule, these exchanges and associations would need to, among other requirements: (1) provide the SEC with their proposed listing standards or amendments that comply with the SEC's final rule no later than 60 days after that rule is published in the Federal Register and (2) have their standards operative no later than one year after that publication date. Sarbanes-Oxley requires the SEC's new rule to become effective by April 26, 2003.

Therefore, the Listing Markets can be expected to harmonise provisions of their earlier proposals with requirements of the final SEC rule in this area – which may also change some effective dates in those proposals. The Listing Markets are not precluded from adopting additional standards as long as they are consistent with the SEC rule.

Figure A-1 provides a comparative summary of selected provisions pertaining to boards and their committees in the Listing Markets' proposed listing standards developed in 2002.



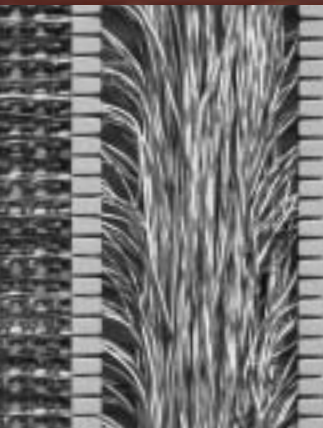
Readers are advised that:

- Current standards for each of the Listing Markets in this area are not presented.
- Because the comparative information is presented in summary form, reference should be made to each of the Listing Markets' specific proposals to identify possibly important points of detail, such as the applicability of exemptions and exceptions covering certain provisions in each proposal.
- Because the proposals are still subject to change, final provisions may differ from information provided herein.

Figure A-1: Comparative Summary of Proposals by NYSE, Amex and NASDAQ

Proposal	NYSE	Amex	NASDAQ
Board of Directors			
Board must have majority of independent directors (allowing for specified exceptions, e.g., “controlled companies,” small business filers).	Y	Y	Y
Director’s independence to be determined with reference to tightened Listing Markets’ criteria and judgment by the board.	Y	Y	Y
Independent or non-management directors must meet at regularly scheduled executive sessions without management present (Amex – as necessary, but at least annually; NASDAQ – except for “controlled companies”).	Y	Y	Y
No Amex employee or floor member may serve on board of any Amex-listed company.		Y	
Company must make timely public disclosure of board changes and vacancies.		Y	
Nominating/Corporate Governance Committee or Equivalent			
Must have committee composed entirely of independent directors (“controlled companies” are excluded).	Y		
Committee must have written charter that addresses, at a minimum:	Y		
<ul style="list-style-type: none"> • Committee’s purpose – identify individuals qualified to become board members; select, or recommend that board select, director nominees (except as provided by law or contract); and develop and recommend to board corporate governance principles for company. • Committee’s goals and responsibilities – reflect board’s criteria for selecting new directors and oversight of evaluation of board and management. • Annual performance evaluation of committee. 			
Charter should give committee authority to retain any search firm to be used for identifying director candidates.	Y		
Nominating committee of independent directors only or majority of independent directors on board must approve board nominations (allowing for specified exceptions).		Y	Y
Compensation Committee or Equivalent			
Committee must be composed entirely of independent directors (“controlled companies” are excluded).	Y		
Committee must have written charter that addresses, at a minimum:	Y		
<ul style="list-style-type: none"> • Committee’s purpose – discharge board’s responsibilities relating to executive compensation and produce annual report on executive compensation for company’s proxy statement. • Committee’s duties and responsibilities – (a) review and approve corporate goals/objectives relevant to CEO compensation, evaluate CEO’s performance and set CEO’s compensation level based on this evaluation; and (b) make recommendations to board regarding incentive-compensation plans and equity-based plans. • Annual performance evaluation of committee. 			
Charter should give committee authority to retain any consulting firm to assist in evaluation of compensation.	Y		
Compensation committee of independent directors only or majority of independent directors on board must approve CEO compensation and compensation of other executives (allowing for specified exceptions).		Y	Y

Proposal	NYSE	Amex	NASDAQ
Audit Committee			
Committee must be composed entirely of independent directors (allowing for specified exceptions).	Y	Y	Y
Expand existing requirements for “being independent” (for example, by adding that such a person may not receive fees from the company for other than board and committee service).	Y	Y	Y
Audit committee chairman and/or one or more members must meet financial expertise criteria specified by each of the Listing Markets.	Y	Y	Y
<p>Committee must have written charter that addresses:</p> <p>Committee’s purpose – at minimum, to:</p> <ul style="list-style-type: none"> Assist board oversight of (1) integrity of company’s financial statements, (2) company’s compliance with legal and regulatory requirements, (3) external auditor’s qualifications and independence and (4) performance of external auditor and internal audit function. Prepare audit committee report required by SEC in annual proxy statement. <p>Committees’ duties and responsibilities – at minimum, to:</p> <ul style="list-style-type: none"> Retain and terminate external auditor (subject, if applicable, to shareholder ratification). Review, at least annually, external auditor’s report describing firm’s quality-control procedures, any material issues raised by latest internal quality-control or peer review of firm or any inquiry or investigation by authorities within preceding five years, and any steps taken to deal with any such issues; and all relationships between external auditor and company. Discuss annual and quarterly financial statements with management and external auditor, including disclosures under “Management’s Discussion and Analysis of Financial Condition and Results of Operations.” Discuss earnings press releases and other financial information and earnings guidance provided to analysts and rating agencies. Obtain advice and assistance from outside advisors as appropriate. Discuss policies regarding risk assessment and risk management. Meet separately, periodically, with management, internal auditor and external auditor. Review with external auditor any audit problems or difficulties and management’s response. Set clear hiring policies for employees or former employees of external auditors. Report regularly to board of directors. <p>Annual performance evaluation of committee.</p> <p>[†] NYSE currently requires audit committee charter but proposes revised, expanded charter as summarised above.</p> <p>^{**} Amex and NASDAQ currently require charters and propose additional responsibilities summarised elsewhere in this table.</p>	Y [†]	Y ^{**}	Y ^{**}
Committee must be responsible for selecting and overseeing external auditor.	Y	Y	Y
Committee must have authority to engage and determine funding for independent counsel and other advisers.	Y	Y	Y
Committee or another independent body of board must provide oversight for (NASDAQ – approve) all related party transactions.		Y	Y



Proposal	NYSE	Amex	NASDAQ
Corporate Governance Guidelines and Codes of Business Conduct			
Company must adopt and disclose corporate governance guidelines that address: <ul style="list-style-type: none"> • Director qualification standards, responsibilities, compensation, orientation and continuing education • Director access to management and, as appropriate, independent advisers • Management succession • Annual performance evaluation of board 	Y		
Company must adopt and disclose code of business conduct and/or ethics for directors, officers and employees.	Y	Y	Y
Code must require that (1) any waiver for executive officer or director be made only by the board (NYSE – or board committee) and (2) any such waiver be promptly disclosed to shareholders.	Y		Y
Additional Provisions			
<i>Internal Audit Function.</i> Company must have internal audit function. Audit committee should assist board in overseeing this function's performance.	Y		
<i>Disclosure by Foreign Issuers.</i> Listed foreign private issuers must disclose any significant ways in which their corporate governance practices differ from those of domestic companies under applicable corporate governance listing standards.	Y	Y	Y
<i>Certification of Compliance with NYSE Standards.</i> Each company CEO must certify to NYSE each year that he or she is not aware of any violation by company of NYSE corporate governance listing standards.	Y		

Appendix B: Other Publications of Interest

Information/Publication	Description	Where to Get It
Corporate Governance and the Board – What Works Best	<p>Publication date: 2000</p> <p>Advises directors on what the board needs to do, and how best to do it in order to deliver shareholder value. This document focuses on best practices and includes a self-assessment guide.</p>	www.pwcglobal.com/corporategovernance
Audit Committee Effectiveness – What Works Best, 2nd edition	<p>Publication date: 2000</p> <p>A companion guide to the above, providing direction to audit committee members regarding how best to carry out their responsibilities. Covers major requirements in place at the time of publication and best practices, including a self-assessment guide.</p>	www.pwcglobal.com/corporategovernance
Current Developments for Audit Committees 2003	<p>Publication date: Jan 2003</p> <p>Updates audit committee members on significant developments of interest, primarily during the past year. Focuses on new and proposed requirements, including guidance from private sector associations such as Business Roundtable and the Conference Board. This document covers future directions in financial reporting, is global in scope and briefly covers the international arena.</p>	www.pwcglobal.com/corporategovernance
Current Developments for Audit Committees 2002	<p>Annual update for 2002, covering the year's business and regulatory developments.</p>	www.pwcglobal.com/corporategovernance
Current Developments for Audit Committees 2002 – Supplement	<p>A follow-on to the above, highlighting issues related to Enron and implications for audit committees.</p>	www.pwcglobal.com/corporategovernance
Emerging Trends in Corporate Governance 2002	<p>Captures the results of Corporate Board Member's Academic Council roundtable held in 2002 and co-sponsored by PwC, bringing together leading academicians.</p>	www.pwcglobal.com/corporategovernance
Sarbanes-Oxley and SEC Rules	<p>Text of the Sarbanes-Oxley Act and related SEC rules and proposed rules, with PwC commentary.</p>	www.pwcglobal.com/sarbanes-oxley
The Sarbanes-Oxley Act of 2002: Strategies for Meeting New Internal Control Reporting Challenges	<p>A PwC white paper, this document presents leading strategies and actions to help management understand and comply with new internal control reporting challenges.</p>	www.cfodirect.com/s-owhitepaper
Discussion on the Hill: The Sarbanes-Oxley Act of 2002. Where Do We Go From Here?	<p>PwC webcast on the legislative changes impacting public companies in the United States, with critical insight from key leaders such as Rep. Michael G. Oxley.</p>	www.cfodirect.com/corpgovernance
Board Governance Webcast Series	<p>PwC participates with other top corporate board advisors in a series of webcasts offering best practice and expert advice on corporate governance.</p>	www.cfodirect.com/boardgovernance

Endnotes

- 1 Committee of Sponsoring Organizations of the Treadway Commission, *Internal Control – Integrated Framework*, 1992, Volume 1, page 22.
- 2 Ibid, page 82.
- 3 The New York Stock Exchange, *Corporate Governance Rule Proposals Reflecting Recommendations from the NYSE Corporate Accountability and Listing Standards Committee As Approved by the NYSE Board of Directors August 1, 2002*.
- 4 The Nasdaq Stock Market, Inc., *Summary of NASDAQ Corporate Governance Proposals As Of November 20, 2002*.
- 5 The American Stock Exchange, *Summary of Corporate Governance Proposals Approved by American Stock Exchange Board of Governors*, November 25, 2002.
- 6 Korn/Ferry International, “Fortune 1000 Board Directors Reveal Gaps in Corporate Governance,” October 17, 2002.
- 7 Caremark, 698 A.2d at 970.
- 8 U.S. Securities and Exchange Commission, “Final Rule: Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002,” 17 CFR Parts 228, 229 and 249; Release Nos. 33-8177, 34-47235; File No. S7-40-02, RIN 3235-AI66. Investment Management Companies are covered by separate provisions included in: “Final Rule: Certification of Management Investment Company Shareholder Reports and Designation of Certified Shareholder Reports as Exchange Act Periodic Reporting Forms; Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002,” 17 CFR Parts 240, 249, 270 and 274, Release Nos. 34-47262, IC-25914, File Nos. S7-33-02; S7-40-02, RIN 3235-AI63; RIN 3235-AI66.
- 9 U.S. Securities and Exchange Commission, “Proposed Rule: Improper Influence on Conduct of Audits,” 17 CFR Part 240, Release Nos. 34-46685, IC-25773; File No. S7-39-02, RIN 3235-AI67.
- 10 U.S. Securities and Exchange Commission, “Final Rule: Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002.”
- 11 Special rules and certain exceptions apply to foreign private issuers.
- 12 U.S. Securities and Exchange Commission, “Proposed Rule: Standards Relating to Listed Company Audit Committees,” 17 CFR Parts 228, 229, 240, 249 and 274; Release Nos. 33-8173, 34-47137, IC-25885; File No. S7-02-03, RIN 3235-AI75.
- 13 In proposing to prohibit national securities exchanges and associations from listing securities of a company not complying with Sarbanes-Oxley requirements for audit committees, the SEC would apply this rule to virtually any type of listed security, including equity, debt and derivative securities. Exemptions are proposed, however, for certain futures and options and for securities of certain specialised companies, as well as specific circumstances. Also, see Section IV for special issues related to non-U.S. issuers.
- 14 U.S. Securities and Exchange Commission, “Proposed Rule: Standards Relating to Listed Company Audit Committees.”
- 15 The SEC has indicated that payments by a company for services to law, accounting or consulting firms, investment banks or similar entities in which its audit committee members are partners, or hold similar positions, are the kinds of compensatory payments that were intended to be prohibited in this test.
- 16 In the case of an investment company, this second prohibition is changed to “may not be an ‘interested person’ of the investment company as defined in Section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19)).”
- 17 U.S. Securities and Exchange Commission, “Final Rule: Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002.”
- 18 U.S. Securities and Exchange Commission, “Proposed Rule: Standards Relating to Listed Company Audit Committees.”

- 19 The SEC is proposing to exempt investment companies from the requirement that audit committees be responsible for selection of external auditors. Section 32(a) of the Investment Company Act requires that external auditors of registered investment companies be selected by a majority vote of the disinterested directors.
- 20 U.S. Securities and Exchange Commission, "Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence," 17 CFR Parts 210, 240, 249 and 274; Release Nos. 33-8183, 34-47265, 35-27642, IC-25915, IA-2103, FR-68; File No. S7-492-02, RIN 3235-A173.
- 21 The SEC rule waives the pre-approval requirements for provision of services other than audit, review or attest services if they do not aggregate more than 5% of total revenues paid by the audit client to the external auditor in the fiscal year when the services are provided (and certain other tests are met) and the service is promptly brought to the audit committee's attention and approved prior to the completion of the audit. Specific provisions apply to investment management companies.
- 22 U.S. Securities and Exchange Commission, "Proposed Rule: Standards Relating to Listed Company Audit Committees."
- 23 Ibid.
- 24 U.S. Securities and Exchange Commission, "Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence." Also, see AICPA, SAS 60, "Communication of Internal Control Related Matters Noted in an Audit," AU §325.
- 25 U.S. Securities and Exchange Commission, "Final Rule: Audit Committee Disclosure," 17 CFR Parts 210, 228, 229 and 240; Release Nos. 34-42266; File No. S7-22-99, RIN 3235-AH83.
- 26 U.S. Securities and Exchange Commission, "Final Rule: Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002."
- 27 U.S. Securities and Exchange Commission, "Final Rule: Strengthening the Commission's Requirements Regarding Auditor Independence."
- 28 U.S. Securities and Exchange Commission, "Final Rule: Audit Committee Disclosure."
- 29 The proposed exemptions and additional disclosures are set forth in U.S. Securities and Exchange Commission, "Proposed Rule: Standards Relating to Listed Company Audit Committees."
- 30 Ibid.
- 31 Ibid.
- 32 The New York Stock Exchange.
- 33 The American Stock Exchange.
- 34 The Nasdaq Stock Market, Inc.
- 35 U.S. Securities and Exchange Commission, "Proposed Rule: Standards Relating to Listed Company Audit Committees."

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Quick Reference Guide for Boards of Directors

Aspect	Major New Requirements in Brief (P) = Proposed (See Note 2)	Page #	Some Key Points to Consider
Independence	<ul style="list-style-type: none"> • Have majority of independent directors (P). • Apply tightened independence criteria (P). 	6 6	<ul style="list-style-type: none"> • Assess need for director changes. • Recruit appropriate qualified candidates. • Review and monitor board member independence. • Provide quality orientation for new directors.
Independent Decisions	<ul style="list-style-type: none"> • Hold executive sessions regularly (P). • Have independent nominating and compensation committees, or majority of independent directors, approve director nominations and executive compensation (P). 	7 8	<ul style="list-style-type: none"> • Use board executive sessions productively, including who presides. • Use independent board committees or majority of independent directors to make board nominations and executive compensation decisions. • Develop metrics for determining executive compensation package, possibly with the counsel of outside specialists.
Corporate Governance Guidelines	<ul style="list-style-type: none"> • If NYSE-listed company, adopt corporate governance guidelines that address specified matters such as director qualification standards, responsibilities and compensation, and performance evaluation of the board (P). 	9	<ul style="list-style-type: none"> • Review/strengthen/formalise guidelines proactively. • Review/develop formal management succession process. • Explore possible ways to strengthen checks and balances between CEO and board functions. • Have clarity of responsibilities and effective communication among the board and committees. • Review/develop process for board and committee evaluation and perform review.
Oversight of Ethical Conduct and Compliance	<ul style="list-style-type: none"> • Have code of conduct and/or ethics. • Approve any waiver of code for directors and executive officers (NYSE and NASDAQ - P). • Avoid improperly influencing external auditor (P). 	11 12 13	<ul style="list-style-type: none"> • Understand board oversight responsibility for ethical conduct and compliance. • Oversee that appropriate code and related policies and process are in place. • Emphasise tone at top and leading by example. • Foster spirit of transparency, accountability and fairness. • Establish process for reviewing waiver requests. • Work with audit committee to understand protocols and practices governing communications with external auditor.
Reporting of Additional Information to the Public	<ul style="list-style-type: none"> • Report new specified information in applicable reports regarding: <ul style="list-style-type: none"> – Whether or not code of ethics in place and any changes – Board independence standards and whether members independent (NYSE - P) – Board changes and vacancies (Amex - P) – Who presides over executive sessions (NYSE - P) • Promptly disclose any waiver of code for CEO or senior financial officers (for directors or executive officers – NYSE and NASDAQ - P). • Make corporate governance guidelines (NYSE - P) and code of ethics available to public. 	14 14 14	<ul style="list-style-type: none"> • Understand what must be reported and when. • Confirm that adequate procedures are in place to develop reliable, complete information. • Review that appropriate, up-to-date information about corporate governance guidelines and code of ethics are maintained on website. Use this platform to convey the quality of corporate governance policies and ethical conduct and values across the organisation. • Have procedures for tracking and prompt reporting of code waivers, as required.
Reaching Beyond	<ul style="list-style-type: none"> • Emphasise director vision, commitment and working as a team. • Understand and consider the company's values, philosophy, mission, strategic plans, business plans, operations and reporting issues in dealing with key matters. • Balance board's oversight and advisory roles relative to shareholders and executive management. 		

Quick Reference Guide for Audit Committees

Aspect	Major New Requirements in Brief (P) = Proposed (See Note 2)	Page #	Some Key Points to Consider
Composition	<ul style="list-style-type: none"> • Have all independent members according to specified criteria (P). • Disclose whether committee has at least one “audit committee financial expert”; have financial expertise as defined by applicable Listing Markets (P). 	19 20	<ul style="list-style-type: none"> • Assess need for membership changes. • Recruit appropriate qualified candidates. • Assist board or nominating committee to review and monitor member independence and financial expertise. • Provide orientation for new members.
Authorities	<ul style="list-style-type: none"> • Be responsible for appointing, compensating, retaining and overseeing work of external auditor (P). • Pre-approve all audit and non-audit services by external auditor. • Resolve any disagreements between management and external auditor pertaining to financial reporting (P). • Establish procedures for handling complaints and confidential submissions regarding accounting, accounting controls and auditing matters (P). • Engage independent advisers as deemed necessary (P). • Determine appropriate funding for external auditor and any advisers (P). 	21 21 21 23 24 25	<ul style="list-style-type: none"> • Establish decision process for appointing and retaining external auditor and overseeing its work. • Apply expanded rules for external auditor independence. • Establish hiring policy covering external auditor employees. • Review that channels and procedures are appropriate governing communications with external auditor. • Obtain and review required communications from external auditor. • Establish pre-approval policies for audit and non-audit services; act judiciously. • Foster and expect quality external auditor services and evaluate performance of external auditor. • Have productive private meetings with external auditor. • Establish procedures for handling complaints and confidential submissions when required. • Consider need for guidelines for selecting and using independent advisers. • Establish procedures for determining appropriate funding for external auditor and any advisers.
Oversight Responsibilities	<ul style="list-style-type: none"> • Have audit committee charter covering specified responsibilities and duties (existing rules; NYSE and NASDAQ - P). • Provide oversight for financial reporting (existing rules; NYSE - P). • Oversee internal audit function (NYSE - P). • Approve related party transactions (NASDAQ - P) or provide oversight (Amex - P). 	25 26 28 29	<ul style="list-style-type: none"> • Establish desired framework for direct and oversight responsibilities. • Make charter responsive to expanded responsibilities and review charter with board, management, counsel and auditors. • Coordinate responsibilities with board and other committees and seek clarity of communication. • Review financial reports, especially critical accounting policies affecting earnings quality, with management and the external auditor. • When made aware of any material weaknesses or other significant deficiencies in controls or of frauds, review management’s remediation. • Review management’s process used in complying with internal control reports filed with the SEC. • Obtain management updates about any unresolved concerns by regulators and other regulatory matters. • Review internal audit’s scope, functional reporting and staffing plans – align internal audit work with needs of committee and management. • Review internal audit’s significant findings and recommendations and monitor actions taken. • Have productive private meetings with internal auditor and possibly others. • Confirm that company has appropriate policies for related party transactions; establish review or approval procedures as required or desired.

Quick Reference Guide for Audit Committees

Aspect	Major New Requirements in Brief (P) = Proposed (See Note 2)	Page #	Some Key Points to Consider
Reporting Responsibilities	<ul style="list-style-type: none"> Report regularly to full board any major issues about company's financial statements, compliance with laws and regulations and external and internal auditors' performance (NYSE - P). 	29	<ul style="list-style-type: none"> Establish procedures for providing meaningful and focused updates to board after each audit committee meeting or other significant activities. Understand required disclosures to public and confirm that procedures are in place to develop reliable and complete information. Review proposed disclosures with board and external auditors and become satisfied that they are reliable and complete.
	<ul style="list-style-type: none"> Disclose specified information pertaining to audit committee in applicable SEC reports about: <ul style="list-style-type: none"> Members' independence and financial expertise Charter, functions and meetings External auditor's approved services and fees 	30	
	<ul style="list-style-type: none"> Provide report stating whether audit committee: <ul style="list-style-type: none"> Has reviewed audited financial statements with management and external auditor and recommended their filing with SEC Has received certain disclosures from auditor regarding its independence Disclose any reliance on specified exemption from certain requirements (P). 	30	
Evaluation & Education	<ul style="list-style-type: none"> Perform annual performance evaluation of committee (NYSE - P). 	33	<ul style="list-style-type: none"> Perform annual performance evaluation that considers best practices and includes feedback from management and external and internal auditors. Assess and increase members' knowledge about company, industry, accounting, auditing and other matters that are important in exercising committee responsibilities effectively.
Reaching Beyond	<ul style="list-style-type: none"> Be the eyes, ears and voice of the board and shareholders as to financial reporting and underlying controls. In addition to asking about critical issues, follow through on their resolution. Apply the spirit of transparency, accountability and integrity in making all decisions. Cultivate strong relationships among audit committee, external and internal auditors and management that bring resources, insights and collaboration to bear in achieving quality financial reporting. 		

Notes:

- These quick-reference guides are provided to help focus on key new and proposed requirements from Sarbanes-Oxley, the SEC and Listing Markets (NYSE, Amex and NASDAQ) involving boards and audit committees. Some opportunities for actions beyond those required are also highlighted. Page references provide a link to where the respective requirements and related key points are considered in this paper.
- Readers are advised to:
 - Reference the statute, current and proposed SEC rules and relevant Listing Markets' standards in considering how these requirements affect individual companies.
 - Address the applicability of exemptions and exceptions contained in the rules and standards.
 - Keep in mind that proposed SEC rules and Listing Markets' standards, as outlined in this paper and guides, may be revised.

Quick Reference Guides for Boards and Audit Committees

Applying Corporate Reform Requirements



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