The Sarbanes–Oxley Act: Rewriting Audit Committee Governance

Stephanie Tsacoumis, Stephanie R. Bess and Bryn A. Sappington*

For those non-US companies that wish to access the US public capital markets, the Sarbanes-Oxley Act of 2002† (“SOX”) has ushered in a new regime of compliance obligations, particularly in relation to audit committees. These compliance obligations, among other things, will impact governance practices, an area traditionally reserved for home jurisdiction regulation.

Notwithstanding accommodations for non-US issuers that have been made by the United States Securities and Exchange Commission (the “SEC”), SOX and the resulting SEC and listing requirements will necessitate a thorough review of audit committee membership and procedures by all non-US companies that are subject to SEC reporting requirements or are listed on a US stock exchange or association.

Just as in the United States, where application of SOX has resulted in concerns about enhanced liability,2 application of SOX requirements to non-US issuers likewise will create the prospect of a heightened standard of care and additional legal exposure. These concerns, coupled with the expense and continuing burden of compliance, could well cause some non-US issuers to re-assess their participation in the US capital markets.

Sarbanes-Oxley and audit committee reform

Intended to address systemic and structural weaknesses affecting US capital markets that manifested failures of audit effectiveness and corporate financial responsibility and

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* Ms. Tsacoumis and Ms. Bess are partners, and Mr. Sappington is an associate, with Gibson, Dunn & Crutcher LLP.
† Pub. L. No. 107-204, 116 Stat. 745 (codified in scattered sections of 11, 15, 18 and 28 U.S.C.), (“SOX”). SOX applies to all US and non-US issuers with debt or equity securities registered under s.12 of the Securities Exchange Act of 1934, as amended (the “34 Act”), or required to file reports under s.15(d) of the 34 Act. A number of entities (including non-US entities) that have registered securities (particularly debt securities) under the Securities Act of 1933, as amended (the “33 Act”), have fewer than 300 US holders and are not required to file reports with the SEC, although many do so voluntarily. The SEC has stated that SOX provisions and related SEC rules that mandate specific disclosures in SEC filings apply to voluntary filers, while SOX provisions aimed only at the conduct of issuers do not apply to voluntary filers. See Division of Corporation Finance, Sarbanes-Oxley Act of 2002 – Frequently Asked Questions (November 8, 2002, revised November 11, 2002), Question 9 (available at www.sec.gov/divisions/corpfin/faqs/saxact2002.htm). In addition, SOX provisions generally do not apply to non-US companies that are exempt under r.12g3-2(b) but who furnish information to the SEC as a condition to the exemption.
2 See Letter from Sullivan & Cromwell LLP to J. Katz, SEC, dated February 18, 2003 (available at www.sec.gov/rules/proposed/ls70203/sullivan2.htm) (noting legitimate audit committee member concern regarding greater liability as compared to other directors).
“threatened the reputation of those markets for integrity.” SOX effected “sweeping corporate disclosure and financial reporting reform” and has fundamentally changed the way public companies in the United States do business. In response to Congressional assessment of the “need for strong, competent audit committees with real authority,” a fundamental aspect of the legislation is strengthening audit committees to “help avoid future auditing breakdowns.” Although the operation and conduct of audit committees historically has primarily been the purview of the jurisdiction of organization of an entity, SOX calls for audit committees to exercise direct and independent oversight of financial reporting, internal controls and outside auditors. At the SEC’s request, and in the wake of SOX provisions and SEC regulations prescribing minimum listing standards, the New York Stock Exchange and Nasdaq have reviewed their corporate governance standards and have proposed rule changes providing more demanding standards for audit committees. SOX provisions thus have resulted in the implementation of a number of specific requirements applicable to the responsibilities, composition and conduct of audit committees. In some instances, these requirements may conflict with applicable law in the home jurisdiction of an entity, and exemptions may not be available. These new requirements thus establish a new US federal regulatory regime governing certain corporate governance practices of public companies; it remains to be seen whether they also establish a new and heightened standard of care.

Audit committee responsibilities

Section 301 of SOX requires the SEC to adopt rules directing the US stock exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with enumerated standards regarding issuer audit committees. Section 301 does not distinguish between US and non-US issuers. Noting the increasing globalization of capital markets, the SEC has asserted that maintaining effective oversight over the financial reporting process is important for listed securities of any issuer, whether domiciled in the United States or elsewhere. Thus, the SEC rules implementing s.301 (the “s.301 Rules”) apply equally to US and non-US listed companies.

Under s.301 of SOX, each audit committee of a listed company is to be “directly responsible for the appointment, compensation, and oversight” of the outside auditor,
and the auditors are to report directly to the audit committee.\(^\text{10}\) Audit committees must establish procedures for complaints regarding accounting and auditing matters and must engage independent counsel and other advisors. The statutory language appears to vest in the audit committee sole oversight authority over the auditor, to the exclusion of management.\(^\text{11}\) Audit committee responsibilities include the authority to terminate the outside auditor\(^\text{12}\) and to approve all audit engagement terms and fees.\(^\text{13}\) These functions, iterated by the SEC as examples, are viewed as promoting auditor independence and aligning the auditor’s interests with those of shareholders.\(^\text{14}\)

Some non-US entities have two-tier boards of directors, with one tier designated as the management board and the other tier designated as the supervisory or non-management board. In these situations, the board of directors means the supervisory or non-management board.\(^\text{15}\)

In adopting the s.301 Rules, the SEC attempted to address specific areas in which non-US governance arrangements differ significantly from general US corporate practices. In a number of non-US jurisdictions, for instance, applicable requirements delegate to shareholders the election, approval or ratification of the issuer’s auditor.\(^\text{16}\) In other jurisdictions, boards are prohibited from delegating certain responsibilities to a committee, including the ability to submit auditor nominations or recommendations to shareholders.\(^\text{17}\) Additionally, in some jurisdictions, the outside auditor can be removed only by court order under certain circumstances.\(^\text{18}\) The SEC clarified in instructions to the rules that the s.301 Rules are not intended to conflict with, or affect the applicability of, home country legal or listing provisions relating to: (1) responsibility for appointment, compensation, retention and oversight of auditors and resolution of disagreements between auditors and management; (2) procedures for complaints relating to accounting

\(^{10}\) In the absence of a formal audit committee, the entire board will be deemed to constitute the audit committee. S.205 of SOX at 774 (codified at 15 U.S.C §78c(a)) (adding s.3(a)(58) to the 34 Act).

\(^{11}\) See n.10 above (defining the term “audit committee” as a separately designated committee (or equivalent) composed of members of its board for the purpose of overseeing the accounting and reporting processes of the issuer and audits of the issuer’s financial statements, or the board of directors if no such committee exists). A non-US issuer that uses the entire board of directors to serve as the audit committee must make related disclosure in its annual report on Form 20-F or Form 40-F. 301 Release at 18,807.


\(^{13}\) 17 C.F.R. §240.10A-3(b)(5).

\(^{14}\) 301 Release at 18,796 (“One way to help promote auditor independence, then, is for the auditor to be hired, evaluated and, if necessary, terminated by the audit committee. This would help to align the auditor’s interests with those of shareholders”).

\(^{15}\) 17 C.F.R. §240.10A-3(e)(2).

\(^{16}\) Letter from Telefonaktiebolaget L.M. Ericsson to J. Katz, SEC (available at www.sec.gov/rules/proposed/s70203/ericsson1.htm) (Sweden fully and exclusively vests shareholders, and not the audit committee, with authority to appoint, nominate, compensate and oversee the auditor).

\(^{17}\) In England, shareholders are responsible for appointing the auditors. See s.385 of the Companies Act 1985 (as amended). In Canada, shareholders are responsible for appointing the auditor, may fix auditor remuneration and have the power to remove the auditor. The board of directors may not delegate to a committee of directors the authority to submit to shareholders any matter requiring shareholder approval. Boards may, however, provide recommendations to shareholders. See Canada Business Corporations Act, R.S.C., ch. C-44, §162 (2003)(Can.). See also Letter from B. Hamilton, Department of Finance, Government of Canada, to SEC (available at www.sec.gov/rules/proposed/s70203/bhamilton1.htm). In Chile, independent auditors are appointed by shareholders. Letter from Compania Cervecerias Unidas S.A. to SEC (available at www.sec.gov/rules/proposed/s70203/cervecerus1.htm). In the United Kingdom, Sweden, Norway and Italy, shareholders are authorized to determine auditor compensation. See Letter from Sullivan & Cromwell LLP to J. Katz, SEC, above n.2.

\(^{18}\) See §318 Abs. 3 HGB (German Commercial Code).
or auditing matters; (3) authority to engage legal and other advisors; and (4) audit committee funding.\textsuperscript{19}

Although SEC regulations are not intended to override non-US requirements relating to these categories of matters ("Audit Requirements"), the SEC has imposed certain requirements that would apply in such jurisdictions under certain circumstances:

- in countries where home country legal or listing provisions require or permit shareholders to ultimately vote on, approve or ratify Audit Requirements,\textsuperscript{20} if the issuer provides a recommendation or nomination regarding such matters, the audit committee of the issuer (or body performing similar functions) must be responsible for making the recommendation or nomination\textsuperscript{21};

- in countries where the home jurisdiction's law or listing requirement prohibits the full board of directors from delegating Audit Responsibilities to an audit committee (or limits the degree of such delegation), the audit committee (or body performing similar functions) must be granted Audit Responsibilities to the extent permitted by law, including submitting nominations or recommendations to the full board\textsuperscript{22}; and

- in a home jurisdiction that vests Audit Responsibilities with a governmental entity or tribunal, the audit committee (or body performing similar functions) must be granted Audit Responsibilities (which can include advisory powers) to the extent permitted by law.\textsuperscript{23}

Thus, even though SEC rules ostensibly do not preempt home jurisdiction law regarding Audit Responsibilities, the impact of the regulations will be to require delegation of Audit Responsibilities to audit committees to the maximum extent allowed by applicable law. Not only will these requirements necessitate an initial analysis of applicable law, but legal developments also will need to be monitored to ensure that delegation of responsibilities to the audit committee continues to reflect the maximum delegation permitted by applicable law over time.

**Audit committee independence**

As expressed by the SEC, "[o]ne of the audit committee's primary functions is to enhance the independence of the audit function, furthering the objectivity of financial reporting."\textsuperscript{24} To the extent that outside auditors view themselves as primarily responsible to management rather than the entire board or the audit committee, "the auditing process may be compromised."\textsuperscript{25}

Under SOX, each member of the audit committee of a listed company must be "independent." Similar to pre-SOX audit committee requirements in the United States and common pre-SOX US practice, audit committees in many non-US jurisdictions need

\textsuperscript{19} See Instructions to 17 C.F.R. §240.10A-3.
\textsuperscript{20} See above n.18.
\textsuperscript{21} Instructions 1 to 17 C.F.R. §240.10A-3.
\textsuperscript{22} \textit{ibid.} Instruction 2.
\textsuperscript{23} \textit{ibid.} Instruction 3.
\textsuperscript{24} 301 Release at 18,796.
\textsuperscript{25} \textit{ibid.}
The Sarbanes–Oxley Act: Rewriting Audit Committee Governance

not, and generally do not, consist solely of independent members. Accordingly, like US listed companies, non-US listed companies will need to reconstitute their audit committees under SOX. If the entire board serves audit committee functions, then the entire board will be required to be independent.

The term “independent” under SOX means that the person, other than in his or her capacity as a director, a member of the audit committee or any other board committee, cannot (1) accept any consulting, advisory or other compensatory fees from the company, or (2) be an affiliated person of the company or any of its subsidiaries. Disallowed payments to audit committee members include indirect payments, such as payments to spouses or immediate family members and payments accepted by an entity in which the committee member is a partner, member or executive officer and which provides accounting, consulting, legal, investment banking or financial advisory services to the listed company or any subsidiary.

Under SOX, the second criterion for determining independence is that the audit committee member may not be an “affiliated person” of the listed company or any subsidiary of the company, apart from the member’s serving as a member of the board and any board committee. The s.301 Rules clarify that the terms “affiliate” and “affiliated person” are to be defined consistently with other usage of the terms under the US securities laws.

Exceptions from independence requirements for non-US entities

Section 301 authorized the SEC to exempt from SOX’s independence requirements particular relationships with respect to audit committee members as the SEC determines to be appropriate under the circumstances. The SEC exercised this authority to adopt specific exemptions from the independence requirements of the s.301 Rules and a general exemption for non-US issuers with listed securities who utilize statutory boards of auditors. Beyond these specific exemptions, the SEC will not permit any other exemptions or waivers from the requirements of the rules for non-US issuers.

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26 For example, the UK Combined Code (as appended to the UK Listing Rules (the “UK Combined Code”)), with which publicly traded UK companies must either comply or disclose their non-compliance, currently provides that a majority of the members of the audit committee should be independent (available at www.fsa.gov.uk/pubs/uklalr/combinedcode.pdf). Several commenters noted that statutory auditors in Japan and audit committees in Spain and Chile, for example, require only a majority of independent members. See Letter from N. Koga, Nomura Holdings, Inc to J. Katz, SEC, dated February 18, 2003 (available at www.sec.gov/rules/proposed/s70203/nkoga1.htm); see also Letter from L. Jorge, Telefonica, S.A., to J. Katz, SEC, dated March 14, 2003 (available at www.sec.gov/rules/proposed/s70203/lrjorge1.htm); see also Letter from Compania Cervecerias Unidas S.A. to SEC, above n.17.

27 17 C.F.R. §240.10A-3(b)(1)(ii)(A) and (B).

28 17 C.F.R. §240.10A-3(e)(8). Note that the proposed NYSE listing standards employ a broader definition of “immediate family.” See NYSE Proposal.

29 s.301 of SOX at 776 (codified at 15 U.S.C. §78j-1(m)(3))(adding s.10A(m)(3) to the 34 Act). Thus, an “affiliate” of a specified person is a person that directly or indirectly controls, is controlled by or is under common control with the specified person. 17 C.F.R. §240.10A-3(e)(1). “Control” likewise is defined consistent with other usage of the term in the US securities laws to mean the direct or indirect possession of the power to direct or cause the direction of management and policies. 17 C.F.R. §240.10A-3(e)(4).

30 2.31 of SOX at 776 (codified at 15 U.S.C. §78j-1(m)(3)(C)).

32 ibid. at II.F.3.a.vii.
Employee representation

Applicable requirements in certain countries provide for the inclusion of non-management employees on the audit committee or board.\(^\text{33}\) Although not “independent” under the SOX definition, such employee audit committee members were viewed by the SEC as providing “an independent check” on management.\(^\text{34}\) Accordingly, the SEC adopted a limited exception from the independence requirements for an employee of a non-US issuer if (i) the employee is not an executive officer of the issuer and (ii) the employee is elected or named to the board or audit committee pursuant to governing law or documents, a collective bargaining or similar agreement or other home country legal or listing requirements.\(^\text{35}\)

Controlling shareholder representation

As reflected in the comment letters submitted by a number of non-US entities, controlling shareholders historically have played a more important role in corporate governance outside the United States than within.\(^\text{36}\) Audit committee representation of controlling shareholders also is more common for many non-US issuers than in the United States.\(^\text{37}\) To accommodate this practice while assuring independent audit committee membership and an independent chair, the SEC adopted in its s.301 Rules an exemption allowing one member of the audit committee to be a shareholder or representative of an affiliate of the issuer if the individual (i) does not accept any consulting, advisory or other compensatory fees from the company; (ii) is a non-voting member of the audit committee and is not the chair of the audit committee; and (iii) is not an executive officer of the company.\(^\text{38}\)

Non-US government representation

Whether the result of privatization initiatives or otherwise, governmental representation on boards of directors and audit committees is common outside the United States.\(^\text{39}\) Due to their equity interests and other rights, these governmental entities may not satisfy the definition of independence under the s.301 Rules. To address foreign practices while excluding management from the committee, the SEC adopted another limited exception to the independence requirements of the s.301 Rules which would exempt one governmental representative member of the audit committee from the independence requirements, provided that the individual: (i) does not accept any consulting, advisory or other compensatory fees from the company; and (ii) is not an executive officer of the company.\(^\text{40}\) Because governmental interests in companies are held and administered in many different forms (encompassing direct holdings by government agencies, indirect holdings through a special corporate form or in the form of stock corporations,

\(^\text{33}\) See 301 Release at 18,802, n. 148.
\(^\text{34}\) ibid. at 18,802.
\(^\text{35}\) 17 C.F.R. §240.10A-3(b)(1)(iv)(C).
\(^\text{36}\) See Letter from Sullivan & Cromwell LLP to J. Katz, SEC, above n.2.
\(^\text{37}\) See 301 Release at 18,802.
\(^\text{38}\) 17 C.F.R. §240.10A-3(b)(1)(iv)(D).
\(^\text{40}\) 17 C.F.R. §240.10A-3(b)(1)(iv)(E).
General exceptions from audit committee requirements for non-US entities

In addition to specific exemptions from the independence requirements, the SEC included in the s.301 Rules a general exemption to accommodate practices in non-US jurisdictions where auditor oversight is handled by a board of auditors, statutory auditors or another body that is separate from the board of directors and whose members would not meet SOX's independence requirements. 43 Under the final s.301 Rules, a non-US issuer with listed securities will be exempt from all audit committee requirements under s.301 if the issuer meets all of the following requirements:

• the non-US issuer must have a board of auditors (or similar body) or statutory auditors ("Board of Auditors") that is established and selected pursuant to home country legal or listing provisions expressly requiring or permitting such a board or body;
• the Board of Auditors must be either separate from the board or must have non-director members;
• the Board of Auditors may not be elected by management of the issuer, and no executive officer may be a member of the Board of Auditors;
• home country legal or listing provisions must provide standards for the independence of the Board of Auditors from the issuer or management of the issuer;
• the Board of Auditors must (in accordance with applicable home country legal or listing requirements or the issuer’s governing documents) be responsible, to the extent permitted by law, for the appointment, retention, oversight (resolution of disagreements with) outside auditors; and
• the remaining requirements of the s.301 Rules (such as the requirements relating to complaint procedures, the ability to engage advisors and funding) must apply to the Board of Auditors, to the extent permitted by law. 44

Although this general exemption is intended to provide relief for certain non-US issuers with listed securities that have a Board of Auditors, such issuers nonetheless will need to undertake a review of each of the specific requirements of the exemption to assess compliance. In particular, the scope of the auditor board’s responsibilities should be reviewed to ensure that it broadly covers oversight of outside auditors to the maximum extent permitted by applicable home country law. All of the other requirements of the

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42 301 Release at 18,803, n.157.
43 Countries whose governance regimes provide for statutory auditors include Italy (see Letter from S. Micossi, Italian Association of Limited Liability Companies to J. Katz, SEC, dated February 18, 2003 (available at www.sec.gov/rules/proposed/s70203/smicossi1.htm)), and Japan (see Letter from N. Koga, Nomura Holdings, Inc to J. Katz, SEC, above n.26.
44 17 C.F.R. §240.10A-3(c)(3).
s.301 Rules will likewise need to be reviewed in light of applicable home country law to ensure that they are applied to the Board of Auditors to the maximum extent permitted by the home country law, as required. In some instances, applicable law may not clearly satisfy the conditions of the general exemption from audit committee requirements under the s.301 Rules and existing practice may not satisfy the condition that the s.301 requirements be satisfied to the extent permitted by applicable law. It is likely, therefore, that difficult legal and factual evaluations will be required – both as an initial matter and on a continuing basis as home country law and practice evolve over time.

Disclosure of reliance on audit committee exemptions

Issuers who rely on exemptions from the s.301 Rules must disclose their reliance on an exemption and their assessment of whether and how such reliance would materially adversely affect the ability of their audit committee to act independently and to satisfy the other requirements of the rules. For non-US issuers, this disclosure would appear in their annual reports and any proxy statements. This provision exceeds the requirements of s.301 of SOX and it is unclear how issuers will determine the impact of an exemption on independence; nevertheless, the SEC declined to exempt non-US issuers from this disclosure requirement.

Financial expert disclosure requirements

The SEC has adopted rules implementing s.407 of SOX requiring non-US issuers to disclose in their annual reports whether the audit committee has at least one “audit committee financial expert.” If no such expert is serving, the issuer must provide an explanation. For non-US issuers that have a Board of Auditors meeting the requirements of the s.301 Rules, this requirement applies to such Board of Auditors. In addition, beginning on July 31, 2005 non-US issuers must disclose whether the expert is independent under applicable listing standards.

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45 See, e.g. Letter from Y. Miyauchi, ORIX Corporation to J. Katz, SEC, dated February 18, 2003 (available at www.sec.gov/rules/proposed/s70203/ymiyauchi1.htm) (noting that the general exemption for non-US issuers with statutory auditors may technically not be available to Japanese companies due to actual practice in Japan); See also Letter from Baker & McKenzie to J. Katz, SEC, dated February 18, 2003 (available at www.sec.gov/rules/proposed/s70203/baker1.htm) (noting that Ukrainian law and listing provisions do not clearly prescribed standards for the independence of the statutory auditing commission as required by the general exemption under the s.301 Rules).

46 17 C.F.R. §240.10A-3(d).

47 ibid. Foreign private issuers file their annual reports with the SEC on either Form 20-F or 40-F.

48 See Letter from Sullivan & Cromwell LLP to J. Katz, SEC, above n.2 (urging an exception from this disclosure requirement for non-US issuers).

49 On Form 20-F or 40-F.


51 Item 16A(a)(3) of Form 20-F; 407 Release at 5,129.

52 If the non-US issuer is not listed, the issuer must choose one of the SRO definitions of independence that has been approved by the SEC and must disclose which standard has been selected. See 301 Release at 18,808.
The Sarbanes–Oxley Act: Rewriting Audit Committee Governance

An “audit committee financial expert” under the SEC rules is an individual who possesses the following attributes, which may have been obtained through education and experience, supervisory experience, analyst experience or through other experience:

- an understanding of generally accepted accounting principles (“GAAP”) and financial statements;
- the ability to assess the applicability of GAAP in connection with the issuer’s financial statements;
- experience in preparing, auditing, analyzing or evaluating, or actively supervising, financial statements comparable to the issuer’s;
- understanding of internal controls and procedures for financial reporting; and
- understanding of audit committee functions.

This definition goes beyond SOX requirements and will result in the imposition of more stringent requirements than those contained in existing New York Stock Exchange and Nasdaq listing rules.

Non-audit services

The SEC has adopted rules relating to auditor independence, which apply to audits of non-US issuers and to non-US accounting firms. These rules limit the scope of the non-audit services that independent accountants can provide to their audit clients, require audit committee pre-approval of the engagement of the auditor and all services provided by the auditor and impose new disclosure requirements.

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53 Subpara (c) to Item 16A of Form 20-F and to General Instruction B, para.8(c) to Form 40-F. 407 Release at 5,129, 5,130.
54 Subpara.(b)(1) to Item 16A(b)(1) of Form 20-F and to General Instruction B, para.8(b) to Form 40-F. 407 Release 5,129, 5,130. Note that the audit committee financial expert’s expertise should be related to GAAP as used in the issuer’s primary financial statements filed with the SEC. See 301 release at 18,809, n.216.
55 Subpara.(b)(2) to Item 16A(b)(1) of Form 20-F and to General Instruction B, para.8(b) to Form 40-F. 407 Release 5,129, 5,130.
56 Subpara.(b)(3) to Item 16A(b)(1) of Form 20-F and to General Instruction B, para.8(b) to Form 40-F. 407 Release 5,129, 5,130. The SEC expanded this requirement from the one originally proposed to allow persons such as analysts, investment bankers and venture capital investors to serve as “audit committee financial experts”. See 407 Release 5,114 (agreeing with comments that “audit committee financial experts” need not have direct experience preparing audited financial statements but may also qualify by virtue of their experience analyzing financial statements.).
57 Subpara.(b)(4) to Item 16A(b)(1) of Form 20-F and to General Instruction B, para.8(b) to Form 40-F. 407 Release 5,129, 5,130.
58 Subpara.(b)(5) to Item 16A(b)(1) of Form 20-F and to General Instruction B, para.8(b) to Form 40-F. 407 Release 5,129, 5,130.
Recommended audit committee practices

The SEC also has observed that many non-US issuers already maintain audit committees and that “the global trend appears to be toward establishing audit committees.”

Although many non-US countries are beginning to focus on the need for audit committees or, where audit committees already are an established part of corporate governance, on the need for audit committee independence, oversight of internal and external auditors by the audit committee and consideration of the potential effect an auditor independence of receiving significant fees for non-audit work, the general approach has differed outside of the United States. Rather than the highly prescriptive approach of SOX and the SEC, the non-US approach to audit committee regulation has tended to be in the nature of “best practices” recommendations or a “comply or disclose” regime. Consequently, non-US issuers that are subject to the SOX audit committee requirements should consider the following practical suggestions.

SOX compliance

Non-US issuers should analyze: (i) the applicability of the various SOX audit committee requirements, (ii) the compliance of the company’s existing governance structure and procedures with the SOX requirements, and (iii) the potential eligibility of the company for exemptions from the SOX requirements. The analysis is not likely either to be intuitive or straightforward. For instance, companies with statutory auditors who seek a general exemption from the s.301 Rules will need to confirm that the statutory auditors are responsible for the relationship with the outside auditors to the maximum extent permitted by law and that all of the remaining requirements of the s.301 Rules also apply to the statutory auditors to the maximum extent permitted by law. An analysis of applicable law will be required, coupled with an analysis of existing practices and the extent to which practice fulfills the s.301 Rule requirements. Although compliance is not required of non-US issuers until July 31, 2005, companies are well advised to initiate the process to ensure adequate time to implement necessary alterations in organization, structure or practice. Having already extended the effective date for non-US issuers, the SEC is unlikely to grant further extensions. Audit committees should request regular briefings on SOX compliance efforts and should monitor progress.

60 Portions of this section are adapted from Olson, Mueller, Tsacoumis and Goodman, “After Enron: Issues for Boards and Audit Committees to Consider” (February 13, 2002).
61 301 Release.
63 See, e.g. Letter from Davis Polk & Wardwell to J. Katz, SEC, above n.41 (arguing for an extension of original April 2004 deadline); see also Letter from JP Morgan Chase Bank to J. Katz, SEC, dated February 13, 2003 (available at www.sec.gov/rules/proposed/s70203/jphmorgn1.htm) (noting difficulty of complying with April 2004 deadline). See also 301 Release at 18,800.
222  The Sarbanes–Oxley Act: Rewriting Audit Committee Governance

Audit committee composition and financial experts

A significant focus of SOX audit committee regulation is audit committee composition—with an emphasis on independence and on financial and accounting acumen. As a threshold matter, absent an applicable exemption, SOX requires that all audit committee members of a listed company be independent. Accordingly, if the general exemption from the s.301 Rules does not apply, the independence of each committee member should be carefully evaluated. In light of the importance of independence in the post-SOX environment, boards and audit committees should re-examine all director relationships, including those that do not necessarily result in disqualification or require disclosure but that could cause investors or regulators to question a director’s independence, particularly in hindsight.

Boards and audit committees also should determine whether an “audit committee financial expert” will serve on the audit committee and if not, what explanation will be disclosed. Inevitably, the need to disclose the absence of such an expert on the audit committee will create significant pressure to appoint a committee member possessing the applicable expertise. Although SOX does not explicitly state who should make the determination regarding expertise, the SEC has indicated that the board of directors as a whole is best equipped to make such evaluations, subject to applicable legal principles such as the business judgment rule. As a result, boards should make every effort to ensure that at least one “audit committee financial expert” serves on the audit committee and that the expert meets applicable independence definitions.

Audit committee communications

One of the central themes to emerge from the Enron failure, among others, was the failure of communication among the company’s management, board of directors, audit committee and outside auditors. As a result, many US audit committees are reevaluating their practices and procedures for communicating with management, internal financial and accounting staff, and outside auditors. In reviewing current practices, audit committee members should schedule committee meetings and agendas that permit and encourage active discussions with management and auditors, both separately and as a group. For example, annual private sessions with internal and outside auditors may not be sufficient; many committees now hold such sessions at every meeting. A one-hour audit committee meeting just before a full board meeting may not suffice. Many audit committees now schedule additional time for meetings to ensure that its agenda is not rushed.

In line with SOX requirements to establish procedures for handling complaints regarding accounting or audit matters, the board and audit committee also should consider whether the company has in place effective mechanisms for company employees, particularly financial and accounting staff and lower level officers, to voice concerns or register complaints about internal controls or financial irregularities.

Communications with management

The audit committee should meet regularly with the chief executive, chief financial and chief accounting officers, not only to discuss accounting and reporting issues but also to

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64 s.301 of SOX at 776 (codified at 15 U.S.C. §78j-1(m)(4))(adding s.10A(m)(4) to the 34 Act).

assess the quality and effectiveness of these officers. Committee members should not avoid thought-provoking questions and should convey to management that they expect to be alerted to potential areas of concern before significant problems develop.

Communications with internal auditors

Regular private sessions between the audit committee and the head of internal audit should be scheduled. If the company does not have an internal audit staff, similar conversations should be held with those responsible for financial reporting. The head of internal audit should be directly accountable to the audit committee, which should oversee the hiring, compensation and career path of employees in the internal audit function. If an outside firm is retained to perform this function, the audit committee should satisfy itself that the company has sufficient expertise to oversee the contractor's performance.

Communications with outside auditors

Consistent with SOX, audit committee members should communicate clearly that the outside auditors are accountable to the board of directors through the audit committee, not to management. Audit committee policies and procedures should facilitate communications between outside auditors and the committee. Outside auditors should be encouraged to disclose all significant areas of concern or discussion with management as to accounting principles or controls, and audit committee members should be proactive in asking questions. For example, audit committee members might ask whether the outside auditor has made any recommendations that management has not followed, whether any issues have been discussed with the auditor's national office, and whether the auditor would make any changes to the financial statements if it were in management's shoes. In both private sessions and meetings involving management, the audit committee should solicit the auditor's views on the overall quality of the company's financial reporting, including financial disclosures and important accounting principles. Although these discussions are important in connection with the annual audit, more frequent communications may be appropriate.

Non-audit services

With a view toward complying with SOX, audit committees should reexamine their companies' practices with respect to non-audit services and should adopt appropriate policies governing the provision of non-audit services by an outside auditor. Such policies are now common in the United States and generally address such issues as categories of prohibited and permitted services and audit committee advance approval thresholds and procedures. Even after adopting such a policy, the audit committee should periodically monitor the non-audit services that actually are being provided by outside auditors, confirm compliance with policy and consider the potential impact on auditor independence of the amount and type of services provided.

Financial management and auditor competence and staffing

Audit committees should meet regularly with senior financial management and with the principal members of the outside auditor's engagement team. The audit committee should use these opportunities to assess the capabilities, professionalism, responsiveness
and candor of the outside auditors. When the outside auditor presents its audit plan and scope, the audit committee should question not only the plan but also critical personnel. The committee should satisfy itself that the audit team has leadership experienced in the relevant market and substantive areas, and should verify that the audit team has access to the relevant technical experts in the auditor's national office.

In private sessions with outside auditors, committee members should ask for candid assessments of senior management (particularly financial management), focusing on the applicable corporate culture and the quality of management's accounting and disclosure judgments. The audit committee also should address these types of issues with internal audit staff or, if there is no internal audit function, with the chief financial officer and controller. Audit committee members should be comfortable with the competence and adequacy of budget and staffing of the company's internal audit and financial accounting staff. If the committee has any concerns about management, the audit engagement team, or key accounting or disclosure policies, committee members should insist on remedial action.

**Related party transactions**

Boards and audit committees should review their existing codes of conduct or conflict-of-interest policies with particular focus on related party transaction practices and procedures and their impact on financial statements. To the extent that waivers or deviations from such policies are permitted, they should be carefully documented and monitored. Company approval procedures should be scrupulously followed, and the audit committee should insist on follow-up reports. In reviewing related party transactions, the audit committee should take an expansive view of what is considered a “related party,” focusing on non-arm's-length transactions in addition to relationships required to be disclosed under SEC or accounting rules.

**Critical accounting policies**

The audit committee's financial statement-related responsibilities, coupled with SOX's emphasis on disclosure controls and procedures and the SEC's recent focus on critical accounting estimates, places a premium on audit committee member understanding of critical accounting policies. The audit committee should participate in a dialogue with financial management and outside auditors to identify the critical accounting policies that most affect their company's financial statements. Committee members should understand these critical principles, how they operate, how they affect reported results and how they compare with principles followed by peer companies. These discussions will require an understanding of the company's business model, and the related financial risks and how they are managed. Every company has its own risk profile. The process of overseeing management as it manages, identifies and responds to such risks is a significant task of any audit committee. To this end, a company's audit committee should consider devoting a portion of its annual agenda to a briefing and dialogue with the

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corporate managers of the company’s various operating groups to understand the risks presented by, and the risk management techniques employed in, those functions or operations.

**Conclusion**

Audit committees and outside auditors now are operating in an environment of heightened scrutiny. Although audit committee conduct historically was primarily within the purview of US state law or non-US home country law, SOX makes the audit committee directly responsible for a number of matters and appears to suggest US federal duties for audit committee members. As a result, the audit committee, whether of a US issuer or a non-US issuer, increasingly has become the focus of SEC attention and audit committee members can expect heightened expectations. Attention therefore should be given to ensuring compliance with applicable requirements, adopting a proactive approach to fulfilling responsibilities and encouraging a company culture that values adherence to the spirit as well as the letter of the law.