

Back To The Future: The Wild Ride Of Today's Audit Committee

Can you assure me that the financial statements are accurate?"

"Can you give us comfort that everything that is material is disclosed in the 10-Q?"

No, this is not part of the SEC Enforcement Division's training primer to identify "cooking the books." Rather, these are two questions that some Audit Committee members are regularly asking their companies' management teams, legal counsel, and auditors.

If you would be uncomfortable answering these, you can appreciate the difficult dynamic permeating many Audit Committee meetings. These kinds of questions are being asked because Sarbanes-Oxley-

GEORGE P. STAMAS
MARK D. DIRECTOR

driven reforms, accounting scandals, fraud prosecutions and greater judicial scrutiny of direc-

tors' actions have added a potent dose of fear and confusion to the already-complex Audit Committee process.

With the list of tasks they must complete now greatly expanded, many Audit Committee members are struggling to fulfill their roles. Some fear they are supposed to be guarantors of corporate financial accuracy. Others think they must function as a securities and accounting oracle.

While the Audit Committee's job is unquestionably more time consuming and demanding than ever before, the new rules and required procedures are largely encouraging (some would say "demanding") Audit Committee members to go back to the basics of being vigorous fiduciaries for stockholders. Behind the internal control reviews, the executive sessions with auditors, and the reviews of disclosure documents and audit reports are the basic, long-standing obligations of the Audit Committee member – like any corporate director – to exercise due care, be loyal to the company and its stockholders, engage in informed decision making, and act in

good faith.

To succeed, today's Audit Committee member must keep in mind that committee members are not alone in the process and are not expected to have the answers or even to be right all of the time. Recent reforms have emphasized that an Audit Committee is a collaboration, and active participation from the key constituents is critical to its success. Committee members must demand participation, but they do not need – and should not try – to fill all of the required roles.

A typical Audit Committee meeting has long involved four main groups of participants: Committee members, company management (including internal audit), the outside auditor, and counsel (inside, outside, or both). These groups must work together if the Audit Committee is to be effective. As the SEC recently wrote, "The audit committee . . . plays a critical role in providing oversight over and serving as a check and balance on a company's financial reporting system. The audit committee provides independent review and oversight of a company's financial reporting processes, internal controls and independent auditors. It provides a forum separate from management in which auditors and other interested parties can candidly discuss concerns."¹ In short, the Audit Committee should collect, evaluate, and examine an array of information from a variety of knowledgeable – and indispensable – sources.

As the NYSE said recently, "[i]t is not the audit committee's responsibility to certify the company's financial statements or to guarantee the auditor's report . . ."² The Audit Committee is one vital part of a process intended to result in the preparation, certification, auditing, and presentation of accurate financial information and informative and truthful public disclosures. To do this properly, each Audit Committee participant must contribute knowledgeably and diligently. The auditor must review, report on, and candidly evaluate the integrity of financial results and financial condition, in light of applicable accounting and

auditing standards. Management must develop and oversee internal control and reporting processes, as well as prepare (and “certify” the accuracy and completeness of) financial statements and public disclosures. Counsel must help decipher applicable laws and rules and render legal judgments and assistance based upon information provided by management, directors and other outside advisors and professionals. Finally, Audit Committee members must ask questions, demand information, review what is given to them, and foster a challenging and thoughtful discussion of the issues. Each participant depends upon the others, and no one participant can provide answers in a vacuum.

The requirements of Sarbanes-Oxley and the proposals of the NYSE and NASDAQ are neither “magic bullets” for the Audit Committee nor answers to the difficult questions that Audit Committee members must confront. Rather, they serve as milestones and procedural safeguards. They are the basis for new Audit Committee “checklists,” which are both daunting and comforting. Their ultimate utility remains to be seen (and certainly those who have grappled with the distinctions between “disclosure controls and procedures” and “internal control over financial reporting” may consider some new rules better suited to a Gabriel Garcia Marquez novel than a regulatory scheme for a public company).

Many of the SEC’s new rules, such as those implementing Sarbanes-Oxley Sections 302 and 404, leave companies with substantial discretion (such as the freedom to decide how to design and implement their control and reporting systems). Accordingly, these new rules will not improve the processes of companies that insist on merely going through the motions, though greater potential penalties for misfeasance or malfeasance may motivate some to be more forthright. They also will not – in and of themselves – provide the Audit Committee with answers.

Similarly, requirements that Audit Committee members be independent, control the relationship with the outside auditor, have resources to hire independent professional advisers, and receive “whistleblower” complaints directly are merely tools that can aid the Committee in performing its oversight role. If the Committee does not take its role seriously, or surrounds itself with unskilled advisers, or lacks the fortitude to question management, these tools will not

improve the Committee’s craftsmanship.

Now more than ever, an Audit Committee member must keep in mind that the job remains bounded by (and grounded in) the contours of corporate fiduciary duties. Although some courts (such as those in Delaware) are looking at directors’ actions and decisions with greater skepticism, the courts continue to show deference to thoughtful, informed, good faith actions and decisions taken in the best interests of a company and its stockholders. Even as the Delaware Chancery Court recently expressed its disdain for “egregious process failures that implicate the foundational directorial obligation to act honestly and in good faith to advance corporate interests,” it noted the tolerance in Delaware corporate law for a director’s “honest errors.”³ No corporate fiduciary – not even an Audit Committee member – is yet required to be either perfect or omniscient to escape liability.

An Audit Committee member who is well informed, asks tough questions, reviews the information being provided, is well organized (to ensure timely completion of the growing “checklist”), and exercises independent judgment can withstand future scrutiny. Of course, figuring out how to do all of this and still keep a “day job” may be the most formidable challenge.

¹ Standards Relating to Listed Company Audit Committees, Securities Act Release No. 8,220; Exchange Act Release No. 47,654, 68 Fed. Reg. 18,788, 18,789 (April 16, 2003).

² Amendment No. 1 to the NYSE’s Corporate Governance Rule Proposals (SR-NYSE-2002-33) at 4 (April 4, 2003).

³ *In re The Walt Disney Company Derivative Litigation*, 825 A.2d 275, 291 (Del Ch. May 28, 2003).

Messrs. Stamas and Director are partners in the corporate practice of Kirkland & Ellis LLP.

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