

## Putting Audit Committee Reform In Its Historical Context: Revolution Or Evolution?

GERALD T. NOWAK  
STEPHANIE S. LIANG

With the recent spate of accounting scandals, corporate governance and financial reporting have never been more topical... or have they? As practicing lawyers, we often become so focused on the practical realities and technical details of the current regulatory agenda that we don't take time to consider these issues in their historical context. Particularly as it relates to the audit committee, what we are seeing is an evolutionary, not revolutionary, modification of its role (and, likely, its legal exposure). In this first of a series of six articles on the topic of corporate governance, we thought it wise to step back and place the audit committee in its historical perspective.

The Securities and Exchange Commission (SEC) endorsed the concept of the audit committee as early as 1940 in its investigation of McKesson & Robbins. Responding to claims by the company's directors that management, not the board, arranged for the audit, the SEC recommended that a committee made up of non-executive directors be established to nominate the external auditing firm and set the parameters of its engagement.

The audit committee movement gathered steam in the late 1960s and 1970s, acquiring wide-

spread acceptance as the proper vehicle for exercising financial oversight by 1980. In 1967, the American Institute of Certified Public Accountants issued a policy statement encouraging public companies to create audit committees composed entirely of outside directors. In 1976, Congress debated a law that would have required public companies to form audit committees composed of independent directors. Despite failing to pass this bill, Congress encouraged the voluntary formation of these committees by enacting the Foreign Corrupt Practices Act (FCPA). Among other reforms, the FCPA required internal accounting controls designed to detect illegal payments and report such payments to the board of directors. In 1978, following on the heels of Congressional action, the New York Stock Exchange (NYSE) required all listed firms to have an audit committee.

In 1985, the National Commission on Fraudulent Financial Reporting (the Treadway Commission) was established to address fraudulent financial reporting. In 1987, the Treadway Commission issued its report, recommending that all public companies form audit committees composed entirely of outside directors. The Treadway Commission has been hailed by Congress, the SEC and others as making a significant contribution to the reduction

of fraudulent financial reporting. In 1989, the National Association of Securities Dealers (NASD) began requiring all companies listed on Nasdaq to establish an audit committee.

In 1996, the Delaware Supreme Court weighed in with the *In re Caremark International Inc. Derivative Litigation* decision. *Caremark* arose in the context of allegedly illegal activities by the company unrelated to financial reporting. Plaintiffs claimed that the directors were derelict in exercising their duty of care for failing to monitor those activities. While the directors in *Caremark* were held to have fulfilled their duty of care, *Caremark* is thought to stand for the proposition that "a director's obligation includes a duty to assure that [adequate] corporate information and reporting systems... exist, and that failure to do so may... render a director liable." While this analysis has not yet been extended by the courts to impose legal standards for financial disclosure, one could easily see this result in the current environment.

The environment heated up in 1998, when SEC chairman, Arthur Levitt, highlighted his concerns regarding financial reporting by public companies. With his speech "The Numbers Game," Chairman Levitt initiated a new focus on deceptive accounting practices,

in response to the market's increasing focus on corporate earnings. Levitt focused on "earnings management," which he believed had the potential to undercut investor confidence in U.S. capital markets by destroying financial reporting transparency and reliability.

Among the initiatives announced by Chairman Levitt was a call to strengthen the audit committee. In response, the NYSE and NASD created the Blue Ribbon Committee (BRC) to recommend ways to improve the committee's oversight process.

Based on the 1999 BRC report recommendations, the SEC approved NYSE and Nasdaq rules regarding audit committees in December 1999. Under these rules, listed companies were required to disclose whether their board had adopted a written audit committee charter and whether the committee members were "independent" as defined in the applicable listing standards. As of January 30, 2000, the SEC began requiring public companies to file audit committee reports.

Four years after Levitt's speech, the financial world was rocked with the current wave of accounting scandals. These scandals, which, for the first time since the crash of 1929, have put corporate governance and financial disclosure consistently on the front pages (not the business pages) of major newspapers, resulted in unusually swift congressional action. With only 165 days elapsed from its introduction through final

passage, the Sarbanes-Oxley Act of 2002 has, for the first time, codified under federal law the requirement for public companies to establish an audit committee consisting solely of independent members.

Many of the Sarbanes-Oxley reforms require SEC rulemaking, and still others will require time and judicial decision-making to fully understand. It should be clear from this brief history lesson, however, that what has occurred is not a 180 degree, or even a 90 degree, turn. Do these recent reforms involve substantial changes? Yes. Do they represent a fundamental shift in regulatory approach? No. If anything, the recent focus on audit committees validates the practical advice that practitioners have been giving for years - the best way to avoid securities law liability is to adopt and follow sound corporate governance and financial reporting practices in the first instance.

*Practitioners seeking a deeper understanding of these issues may wish to review the following sources: Report of the National Commission on Fraudulent Financial Reporting (1987); In re Caremark International Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996); and Report and Recommendation of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (1999).*

*Mr. Nowak is a partner and Ms. Liang is an associate in Kirkland & Ellis' corporate practice.*