



Financial Reporting

March 2000

New Audit Committee Rules

Executive Summary

In response to recommendations made by the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, the SEC recently issued new rules. The SEC's rules have generally not exempted small business filers (except as noted) and require:

- independent auditors to review companies' interim financial information prior to the filing of a Form 10-Q or Form 10-QSB;
- non-small business filers to include quarterly information in their annual filings;
- companies to include reports from their audit committee in proxy statements; and
- companies to include in their proxy statements certain disclosures about their audit committee.

Additionally, the stock exchanges changed their rules regarding the number, qualifications and independence of audit committee members. In general, the effective dates are as follows:

- Quarterly financial statements are required to be reviewed for all fiscal quarters ending after March 15, 2000.
- New proxy disclosures are required for proxies and information statements relating to votes of shareholders occurring after December 15, 2000.
- Quarterly information is required to be included in annual filings made after December 15, 2000.
- For companies listed as of December 14, 1999, changes to stock exchange rules discussed in the Appendix section of this newsletter are effective:

- as of June 14, 2000 for adopting a formal written audit committee charter; and
- as of June 14, 2001 for meeting the audit committee structure and membership requirements.

New Rules and Amendments

Pre-Filing Review of Quarterly Financial Statements and Quarterly Information

The SEC adopted amendments to Rule 10-01(d) of Regulation S-X and Item 310(b) of Regulation S-B which require that a company's interim financial statements be reviewed by an independent auditor prior to filing its Form 10-Q or 10-QSB with the Commission. The independent auditor is required to follow "professional standards and procedures for conducting such reviews, as established by generally accepted auditing standards, as may be modified or supplemented by the Commission." These auditing procedures are set forth in SAS 71, "Interim Financial Information." While reviewed interim data, included in a footnote, have previously been required for companies meeting certain tests, the rules did not require performance of these reviews on a timely basis. The amendments expand the scope of these reviews and accelerate their timing.

The SEC believes that requiring these timely quarterly reviews by independent auditors will:

- facilitate early identification and resolution of material accounting and reporting issues;
- reduce the likelihood of restatements or other year-end adjustments;

Contents

Executive Summary.....	1
New Rules and Amendments.....	1
Appendix.....	3

- enhance the reliability of financial information; and
- deter inappropriate earnings management caused by the increasing pressure to “manage” interim financial results due to changes in the markets.

Several commenters on the proposed rules expressed concern about the cost of obtaining interim reviews, particularly for small business issuers. However, the SEC believes these quarterly reviews are important for companies of all sizes (as supported by the COSO report), and therefore has not exempted small business filers.

The SEC also amended Item 302(a) of Regulation S-K, which requires a footnote with quarterly information and appropriate reconciliations and descriptions of adjustments to quarterly information previously reported. This amendment extends the Item 302(a) requirements to all companies (except small business issuers filing on small business forms) that have securities registered under Sections 12(b) or 12(g) of the Exchange Act, regardless of the size of the company or public float. Item 302(a) previously required only larger, widely-held companies to provide these disclosures.

The Audit Committee Report

The SEC has adopted new Item 306 of Regulations S-K and S-B and Item 7(e)(3) of Schedule 14A that requires the audit committee to provide a report in the company’s proxy statement. This disclosure requirement is intended to help inform shareholders of the audit committee’s oversight with respect to financial reporting, and underscore the importance of that role. The adoption of Item 306 requires the audit committee to state whether it has:

1. reviewed and discussed the audited financial statements with management;

2. discussed with the independent auditors the matters required to be discussed by SAS 61 “Communications with Audit Committees” (which has subsequently been amended by SAS 90, “Audit Committee Communications”) and as may be further modified or supplemented;
3. received the written disclosures and the letter from the independent auditors required by Independence Standards Board Standard No. 1, “Independence Discussions with Audit Committees” as may be modified or supplemented, and discussed with the auditors the auditors’ independence; and
4. based on the review and discussions referred to in items 1, 2, and 3 above, recommended to the board of directors that the financial statements be included in the Annual Report on Form 10-K or 10-KSB for the last fiscal year for filing with the Commission.

Items required to be communicated to the audit committee by SAS 61 and SAS 90 include the selection of significant accounting policies, significant accounting estimates made by management, significant audit adjustments, any disagreements with management and the quality of the company’s accounting principles, among other disclosures. In regard to item 4 above, the SEC did not adopt the proposal recommended by the Blue Ribbon Committee to require the audit committee to affirmatively state that it believes the company’s financial statements are fairly presented in conformity with GAAP, because of concerns about liability raised by commenters to the original proposal. Commenters noted that the additional liability would make it harder to attract and retain knowledgeable

audit committee members. Instead, the SEC’s rules require the audit committee to indicate whether, based on its discussions with management and the auditors, its members became aware of material misstatements or omissions in the financial statements.

If the company does not have an audit committee, the Board committee with similar responsibilities, or the full Board of Directors, would be responsible for the disclosure.

The SEC also adopted the requirement that the new disclosure appear over the printed names of each member of the audit committee. This will emphasize to shareholders the importance of the audit committee’s oversight role in the financial reporting process.

The disclosure needs to be provided annually (in a proxy statement for an annual meeting at which directors are to be elected, but not in proxy solicitation material used in a subsequent election contest during that same year).

Audit Committee Charters

The SEC adopted new paragraph (e)(3) under Item 7 of Schedule 14A, which requires a company to disclose in its proxy statement whether its audit committee is governed by a charter. If governed by a charter, the company must include a copy of the charter as an appendix to the proxy statement at least once every three years. This new disclosure requirement is intended to help shareholders assess the role and responsibilities of the audit committee. Although not an SEC requirement, the revised listing requirements of the NYSE, AMEX and Nasdaq do require audit committee charters. See the Appendix section of this newsletter.

Disclosures about Independence of Audit Committee Members

The SEC has adopted the requirement that companies whose securities are

listed on the NYSE or AMEX or quoted on Nasdaq (“listed companies”) that have a non-independent audit committee member disclose the nature of the relationship that makes that individual not independent and the reasons for the determination of the Board of Directors to appoint the director to the audit committee. In addition, listed companies must disclose whether the audit committee members are independent, as defined in the applicable listing standards. Small business issuers are not required to comply with this requirement. See the Appendix section of this newsletter.

The SEC has also adopted the requirement that companies, including small business issuers, whose securities are not listed on the NYSE or AMEX or quoted on Nasdaq, disclose in their proxy statements whether, if they have an audit committee, the members are independent as defined in the NYSE’s, AMEX’s, or Nasdaq’s listing standards, and which definition of independence was used. These companies would be able to choose which definition of independence to apply to the audit committee members in making the disclosure. Whichever definition is chosen must be applied consistently to all members of the audit committee.

Safe Harbors

The SEC has adopted “safe harbors” for the new disclosures that will track the treatment of compensation committee reports under Item 402 of Regulation S-K. These “safe harbors” are in paragraph (c) in new Item 306 of Regulations S-K and S-B and paragraph (e)(v) of Schedule 14A. Under the “safe harbors,” the additional disclosures will not be considered “soliciting material” and will therefore not be subject to the antifraud provisions of Rules 14a-9 or 14c-6 or to the liabilities of Section 18 of the Exchange Act.

Appendix

Summary of New York Stock Exchange Rules - Audit Committees

Effective December 14, 1999, the NYSE rule changes were approved by the SEC. They include the following:

1. **Audit Committee Charter.** The Board of Directors must adopt and approve a formal written charter for the audit committee. The audit committee must review and reassess the adequacy of the audit committee charter on an annual basis. The charter must specify the following:
 - The scope of the audit committee's responsibilities and how the committee carries out those responsibilities, including the structure, processes and membership requirements
 - That the independent auditor is ultimately accountable to the Board of Directors and audit committee
 - That the audit committee is responsible for the selection, evaluation and replacement of the company's auditor
 - That the audit committee is responsible for ensuring the auditor's independence by requiring that the independent auditor submit a formal written independence letter on a periodic basis and by monitoring disclosed relationships or services that may impact objectivity or independence
2. **Composition of the Audit Committee.** The audit committee must consist of at least three independent directors, none of whom can have a relationship with the company or management that may interfere with the exercise of their independent judgement.
- Each member of the audit committee must be financially literate, as such qualification is interpreted by the Board of Directors in its business judgment, or must become financially literate within a reasonable period of time after his or her appointment to the audit committee.
- At least one member of the audit committee must have accounting or related financial management expertise, as the Board interprets such qualifications in its business judgment.
3. **Definition of Independence.**
 - *Employees.* A director who is an employee (including non-employee executive officers) of the company or any of its affiliates is not considered independent until three years following termination of his or her employment.
 - *Business Relationship.* A director who is a partner, controlling shareholder, or executive officer of an organization that has a business relationship with the company, or who has a direct business relationship with the company (e.g., consultant), may serve on the audit committee only if the company's Board of Directors determines in its business judgment that the relationship does not interfere with the director's exercise of independent judgment.
 - A business relationship can include commercial, industrial, banking, consulting, legal, accounting and other relationships.
 - The director can serve on the audit committee

without the above-referenced Board of Directors determination after three years following the termination of the relationship.

- *Cross Compensation Committee Link.* A director who is employed as an executive of another corporation where any of the company's executives serve on that corporation's compensation committee may not serve on the audit committee. For example, assume Bill Jones, EVP of ABC Bancorp, serves on the compensation committee of the Board of XYZ Manufacturing Company where John Smith is employed as the COO. John Smith, a director of ABC Bancorp, cannot serve on ABC Bancorp's audit committee.
 - *Immediate Family.* A director who is an immediate family member of an individual who is an executive officer of the company or any of its affiliates cannot serve on the audit committee until three years following the termination of such employment relationship.
 - Application of above terms:
 - "Immediate Family" means a person's spouse, parents, children, siblings, mothers-in-law and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, and anyone (other than employees) who shares such person's home.
 - "Affiliate" includes a subsidiary, sibling company, predecessor, parent company, or former parent company.
 - "Officer" has the meaning specified in Rule 16a-1(f) under the 1934 Act.
4. **Written Affirmation.** As part of the initial listing process, and with respect to any subsequent changes to the composition of the audit committee, and otherwise approximately once each year, written confirmation regarding the following is required:
- Independence of directors pursuant to the above
 - Financial literacy of the audit committee members
 - Determination that at least one of the audit committee members has accounting or related financial management expertise
 - Annual review and reassessment of the adequacy of the audit committee charter
5. **Exception for One Director.** Notwithstanding the above requirements, one director who is no longer an employee (i.e., no exception for employee directors) or who is an immediate family member of a former executive officer of the company or its affiliates, but is not considered independent due to the three-year restriction period, may be a member of the audit committee, under exceptional and limited circumstances, if:

- The Board of Directors determines in its business judgment that membership by the individual is required in the best interests of the company and its shareholders; and
 - The company discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.
6. **IPOs.** Companies listing in conjunction with their IPO (including spin-offs and carve-outs) will be required to have two qualified audit committee members in place within three months of listing and a third qualified member in place within twelve months of listing.
7. **Transition of NYSE Requirements.**
- Grandfathers all public company audit committee members until they are re-elected or replaced. For companies whose entire Board will stand for re-election in the year 2000, this means that following the annual meeting of shareholders which occurs this year, members of the audit committee must be qualified under the new standards.
 - Provides an 18-month grace period (through June 14, 2001) for committees with fewer than three members or if the audit committee lacks a member with the required accounting or related financial management expertise.
 - Allows issuers listed on the NYSE as of December 14, 1999 to have six months (until June 14, 2000) to adopt a formal written audit committee charter.
 - New applicants for listing after December 14, 1999 must comply with these rules.

Summary of American Stock Exchange Rules - Audit Committees

Effective December 14, 1999, the AMEX rule changes were approved by the SEC. They include the following:

1. **Definition of Independent Director.** AMEX requires that domestic listed companies have a sufficient number of independent directors to satisfy the audit committee requirements set forth below. It should be noted that AMEX narrowed its current definition of "independent directors." The definition will apply to all directors, not just those serving on audit committees. The following persons are not considered independent:
- A director who is employed by the company or any of its affiliates for the current year or any of the past three years
 - A director who accepts any compensation from the company or any of its affiliates in excess of \$60,000 during the previous fiscal year, other than compensation for Board service, benefits under a tax-qualified retirement plan, or non-discretionary compensation

- A director who is a member of the immediate family of an individual who is, or has been in any of the past three years, employed by the company or any of its affiliates as an executive officer.
 - Immediate family members include a person's spouse, parents, children, siblings, mother-in-law, father-in-law, brothers and sisters-in-law, sons and daughters-in-law and anyone who resides in such person's home
 - A director who is a partner in, or a controlling shareholder or executive officer of, any for-profit business to which the company made, or from which the company received, payments (other than those arising solely from investments in the company's securities) that exceeded 5% of the company's consolidated gross revenues for that year, or \$200,000, whichever is greater, in any of the past three years
 - A director who is employed as an executive of another entity where any of the company's executives serve on that entity's compensation committee. For example, assume Bill Jones, EVP of ABC Bancorp, serves on the compensation committee of the Board of XYZ Manufacturing Company where John Smith is employed as the COO. John Smith, a director of ABC Bancorp, would not be considered an independent director of ABC Bancorp
2. **Formal Written Charter.** The company must certify that it has adopted a formal written audit committee charter and that the audit committee has reviewed and reassessed the adequacy of the charter on an annual basis. The charter must specify the following:
- The scope of responsibilities of the audit committee and how it carries out those responsibilities, including structure, processes and membership requirements
 - That the independent auditor is ultimately accountable to the Board of Directors and the audit committee
 - That the audit committee is responsible for the selection, evaluation and replacement of the independent auditor
 - That the audit committee is responsible for ensuring the auditor's independence by requiring that the independent auditor submit a formal written independence letter on a periodic basis and by monitoring disclosed relationships or services that may impact objectivity or independence
3. **Audit Committee Composition.** The company must certify that it has and will continue to have an audit committee with the following membership requirements:
- There must be a minimum of three independent directors.
 - All of the audit committee members must be able to read and understand fundamental financial statements, including a balance sheet, income statement and cash flow statement or will become able to do so within a reasonable period of time after his or her appointment to the audit committee.
 - At least one member must have past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.
 - Notwithstanding the above, one director who is not independent and is not a current employee or immediate family member of such employee (i.e., no exceptions for employees and their immediate family members) may be a member, under exceptional and limited circumstances, if:
 - The Board of Directors determines that membership is required by the best interests of the company and its shareholders, and
 - The Board of Directors discloses, in the annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.
 - Small business issuers - The above (i.e., three independent members and financial literacy) does not apply to issuers that file reports under SEC Regulation S-B. Such issuers must establish and maintain an audit committee of at least two members, a majority of which must be independent directors.
 - Small business issuers are permitted to disclose that the listing standards of AMEX do not require that all members of their audit committees be independent.
 - A small business issuer is defined by Regulation S-B as an issuer that (a) has revenue of less than \$25 million, (b) has a public float (the aggregate market value of outstanding voting and non-voting common equity held by non-affiliates) of less than \$25 million, (c) is a U.S. or Canadian issuer, and (d) if a majority-owned subsidiary, the parent company is a small business issuer.
4. **Transition of AMEX Requirements.**
- Issuers listed as of December 14, 1999, have 18 months (through June 14, 2001) to meet the audit committee structure and membership requirements.

- Issuers listed as of December 14, 1999, have six months (until June 14, 2000) to adopt a formal written audit committee charter.
- New applicants for listing after December 14, 1999 must comply with these rules.

Summary of Nasdaq Rules - Audit Committees

Effective December 14, 1999, the Nasdaq rule changes were approved by the SEC. They include the following:

1. **Definition of Independent Director.** Nasdaq requires that domestic listed companies have a sufficient number of independent directors to satisfy the audit committee requirements set forth below. It should be noted that Nasdaq narrowed its current definition of "independent directors." The definition will apply to all directors, not just those serving on audit committees. The following persons are not considered independent:
 - A director who is employed by the company or any of its affiliates for the current year or any of the past three years
 - A director who accepts any compensation from the company or any of its affiliates in excess of \$60,000 during the previous fiscal year, other than compensation for Board service, benefits under a tax-qualified retirement plan, or non-discretionary compensation
 - A director who is a member of the immediate family of an individual who is, or has been in any of the past three years, employed by the company or any of its affiliates as an executive officer
 - Immediate family members include a person's spouse, parents, children, siblings, mother-in-law, father-in-law, brothers and sisters-in-law, sons and daughters-in-law and anyone who resides in such person's home.
 - A director who is a partner in, or a controlling shareholder or executive officer of, any for-profit business to which the company made, or from which the company received, payments (other than those arising solely from investments in the company's securities) that exceeded 5% of the company's consolidated gross revenues for that year, or \$200,000, whichever is more, in any of the past three years.
 - A director who is employed as an executive of another entity where any of the company's executives serve on that entity's compensation committee. For example, assume Bill Jones, EVP of ABC Bancorp, serves on the compensation committee of the Board of XYZ Manufacturing Company where John Smith is employed as the COO. John Smith, a director of ABC Bancorp, would not be considered an independent director of ABC Bancorp.
2. **Formal Written Charter.** The company must certify that it has adopted a formal written audit committee charter and that the audit committee has reviewed and reassessed the adequacy of the charter on an annual basis. The charter must specify the following:
 - The scope of the audit committee's responsibilities and how the committee carries out those responsibilities, including structure, processes and membership requirements
 - That the independent auditor is ultimately accountable to the Board of Directors and audit committee
 - That the audit committee is responsible for selection, evaluation and replacement of the independent auditors
 - That the audit committee is responsible for ensuring the auditor's independence by requiring that the independent auditor submit a formal written independence letter on a periodic basis and by monitoring disclosed relationships or services that may impact objectivity or independence.
3. **Audit Committee Composition.** The company must certify that it has and will continue to have an audit committee with the following membership requirements:
 - There must be a minimum of three independent directors.
 - All of the audit committee members must be able to read and understand fundamental financial statements, including a balance sheet, income statement and cash flow statement or will become able to do so within a reasonable period of time after his or her appointment to the audit committee.
 - At least one member must have past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.
 - Notwithstanding the above, one director who is not independent and is not a current employee or immediate family member of such employee (i.e., no exceptions for employees and their immediate family members) may be a member, under exceptional and limited circumstances, if:
 - The Board of Directors determines that membership is required by the best interests of the company and its shareholders, and
 - The Board of Directors discloses, in the annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.

-
- Small business issuers - The above (i.e., three independent members and financial literacy) does not apply to issuers that file reports under SEC Regulation S-B. Such issuers must establish and maintain an audit committee of at least two members, a majority of which must be independent directors.
 - Small business issuers are permitted to disclose that the listing standards of Nasdaq do not require that all members of their audit committees be independent.
 - A small business issuer is defined by Regulation S-B as an issuer that (a) has revenue of less than \$25 million, (b) has a public float (the aggregate market value of outstanding voting and non-voting common equity held by non-affiliates) of less than \$25 million, (c) is a U.S. or Canadian issuer, and (d) if a majority-owned subsidiary, the parent company is a small business issuer.

4. **Transition of Nasdaq Requirements.**

- Issuers listed as of December 14, 1999, have 18 months (through June 14, 2001) to meet the audit committee structure and membership requirements.
- Issuers listed as of December 14, 1999, have six months (until June 14, 2000) to adopt a formal written audit committee charter.
- New applicants for listing after December 14, 1999 must comply with these rules.

Material discussed in this *Financial Reporting* newsletter is meant to provide general information and should not be acted upon without first obtaining professional advice appropriately tailored to your individual facts and circumstances.

BDO

BDO Seidman, LLP
770 Kenmoor S.E.
Suite 300
Grand Rapids, Michigan 49546

BULK RATE
U.S. POSTAGE
PAID
PERMIT #1
GRAND RAPIDS, MI