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REPORT AND RECOMMENDATIONS

OF THE

BLUE RIBBON COMMITTEE ON

IMPROVING THE EFFECTIVENESS OF  
CORPORATE AUDIT COMMITTEES

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# Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees

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A few Committee members had varying degrees of comfort with a few of the recommendations advanced in this Report. Nevertheless, the Report reflects a fair consensus of Committee members' viewpoints.

Additional copies of this Report can be obtained by contacting Murray Teitelbaum at the New York Stock Exchange at (212) 656-2017, or Andrew MacMillan at the National Association of Securities Dealers at (202) 728-8340. The Report may also be found on-line at [www.nyse.com](http://www.nyse.com) or [www.nasd.com](http://www.nasd.com).

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## Letter From the Chairmen

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*Dear Messrs. Grasso and Zarb:*

Since the end of September 1998, when you called upon us to chair this Blue Ribbon Committee, we have been honored to work with our fellow Committee members on what we believe to be a truly collaborative effort.

We are pleased to submit to you this Report and Recommendations, but wish to acknowledge that much of our work is based on the outstanding research and best practices documents previously drafted and disseminated by others. In particular, the Committee wishes to commend and thank those responsible for the Report of the National Commission on Fraudulent Financial Reporting (Treadway Commission (1987)) and Strengthening the Professionalization of the Independent Auditor, Report to the Public Oversight Board of the SEC Practice Section, American Institute of Certified Public Accountants (AICPA) from the Advisory Panel on Auditor Independence (1994) ("1994 POB Report") -- both resources the Committee used liberally.

This Report, however, is not intended to cover the breadth of financial reporting issues addressed by these and other prior reports. Nor does this Report focus on fraud per se, although many of our recommendations may reduce the possibility of fraud. The Committee's focus is on the large grey area where discretion and subjective judgments bear on the quality of financial reporting. It is not possible to lay down hard and fast rules where discretion is required. Accordingly, we emphasize the need for financial management to make sound financial judgments and the process by which the outside auditors and the audit committee evaluate those judgments.

Our Report is geared toward effecting pragmatic, progressive changes in the functions and expectations placed on corporate boards, audit committees,

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senior and financial management, the internal auditor, and the outside auditors regarding financial reporting and the oversight process. Underpinning our work is the recognition that quality financial accounting and reporting can only result from effective interrelationships among these relevant corporate participants.

Throughout our deliberations we have strived to produce recommendations that promote quality financial reporting, recognizing the benefits that inure from this practice: market confidence, a more efficient allocation of capital, and the resulting lower cost of capital. The strength of America's capital markets always has been their adherence to transparency and full disclosure.

Because so many groups within the corporate community are vested in some aspect of board oversight and the financial reporting process, you have assembled in this Committee representatives from the whole spectrum of the interested parties. In this spirit, the Committee gathered input from a wide range of constituencies through a public hearing and open request for formal written comments on the topic. The Committee would like to thank the following organizations and individuals for their testimony at the December 9, 1998, public hearing and for their formal written comments: William T. Allen, Independence Standards Board; Curtis H. Barnette, The Business Roundtable; William G. Bishop, Institute of Internal Auditors; Kathleen Gibson, American Society of Corporate Secretaries; Joseph Hinsey IV, Harvard Business School; Kenneth S. Janke, National Association of Investors Corporation; Donald J. Kirk, Public Oversight Board; Olivia F. Kirtley, American Institute of Certified Public Accountants; John M. Nash, National Association of Corporate Directors; William B. Patterson, AFL-CIO; P. Norman Roy, Financial Executives Institute; Richard M. Swanson, Institute of Management Accountants; and Sarah Teslik, Council of Institutional Investors.

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The Committee would also like to express its appreciation to the following organizations and individuals for their submissions and thoughtful comments and contributions on the topic: Louis Braiotta, Jr., School of Management, Binghamton University; Stephen Butler and Anthony V. Nicolosi, KPMG LLP; Joseph V. Carcello, College of Business Administration, University of Tennessee, Knoxville; J. Michael Cook, Deloitte & Touche LLP; John F. Flaherty, Committee of Sponsoring Organizations of the Treadway Commission; Ray J. Groves; P. Brett Hammond, TIAA-CREF; Roderick Hills; Edmund L. Jenkins, Financial Accounting Standards Board; Anthony M. Knapp, Motorola, Inc.; Frederick Lipman, Blank Rome Comisky & McCauley; Felix Pomeranz; Louis Salvatore, Arthur Andersen LLP; Ralph S. Saul; John Smale and Michael Losh, General Motors Corporation; Curtis C. Verschoor, School of Accountancy, DePaul University; and Michael R. Young, Willkie Farr & Gallagher.

And special appreciation to Paula Lowitt, Esq., and other attorneys at Weil, Gotshal & Manges LLP, whose organization of our work and preparation of initial working drafts of this Report made timely presentation possible.

Finally, we applaud the current parallel efforts by other organizations, namely the Public Oversight Board's Panel on Audit Effectiveness, the National Association of Corporate Directors' Blue Ribbon Commission on Audit Committees, and the Independence Standards Board.

The substantive matters covered by the Committee's recommendations have been studied and commented upon by business and professional groups, and scholars, for years. This time, because of how, and by whom, this Committee was convened, the Committee anticipates prompt and serious con -

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sideration of formal implementation of the Committee's recommendations on the part of the SEC, the NYSE, the NASD, and the accounting profession. The precise forms of implementation are, obviously, the domain of each of them; it is the substance of our recommendations that we trust will be considered and implemented. The Committee anticipates, too, that its recommendations will be seriously considered by newly energized audit committees -- even as the regulatory and self-regulatory bodies engage in their implementation processes. Corporate governance should be a do-it-yourself kit, and audit committees can, if they wish to, start the improvement process immediately without formal rules, standards and regulations; the Committee urges audit committees to take such voluntary action. Precipitating action this time will be the reward for the voluntary efforts the Committee extended, as well as the voluntary efforts of all of those who assisted the Committee through testimony, comment, and debate.

We appreciate the opportunity to serve on the Committee and to contribute to this important area.

Sincerely,



John C. Whitehead



Ira M. Millstein



## Overview and Recommendations

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Recommendations for the performance of audit committees must be founded in the practices and attitudes of the entire board of directors. We, therefore, at the outset, urge boards of directors to understand and adopt the attitude of the modern board which recognizes that the board must perform active and independent oversight to be, as the law requires, a fiduciary for those who invest in the corporation. Board membership is no longer just a reward for “making it” in corporate America; being a director today requires the appropriate attitude and capabilities, and it demands time and attention.

The measure of the board, then, is not simply whether it fulfills its “legal” requirements but, more importantly, the board’s attitude and how it puts into practice its awareness and understanding of its responsibilities. Is the board simply going through the motions, or has it demonstrated awareness of its important role by having some form of independent leadership that can act without relying only on management’s initiative? Has the board established guidelines or operational procedures for its own functioning? Do the independent directors meet alone periodically to evaluate management and company performance and strategy? Does the board engage in individual director and full board evaluation? From self-generated measures such as these, one can infer that the board is aware, independent, professional and well-governing, or at least is endeavoring to be distinct from management. In essence, these signs show that a board is moving from being passive to active.

If a board is functioning properly, the audit committee can build

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on and relate to these very same board-wide principles. If the board is dysfunctional, the audit committee likely will not be much better. We cannot, however, suggest a single appropriate template for oversight by all audit committees. Just as “one size doesn’t fit all” when it comes to board governance, “one size can’t fit all” audit committees. Within broad parameters, each audit committee should evolve and develop its own guidelines suited to itself and its corporation.

A starting point for the development of audit committee guidelines is a recognition of the audit committee’s position in the larger governance process as it relates to the oversight of financial reporting. Certainly, it is not the role of the audit committee to prepare financial statements or engage in the myriad of decisions relating to the preparation of those statements. The committee’s job is clearly one of oversight and monitoring, and in carrying out this job it acts in reliance on senior financial management and the outside auditors. A proper and well-functioning system exists, therefore, when the three main groups responsible for financial reporting -- the full board including the audit committee, financial management including the internal auditors, and the outside auditors -- form a “three-legged stool” that supports responsible financial disclosure and active and participatory oversight. However, in the view of the Committee, the audit committee must be “first among equals” in this process, since the audit committee is an extension of the full board and hence the ultimate monitor of the process.

Turning from awareness and execution of responsibilities to another modern element of governance, we note that disclosure and transparency have become the first hallmark of good governance looked to by investors. The lack of disclosure and transparency no doubt con-

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tributed to the recent flight of capital from Asia. If a corporation is to be a viable attraction for capital, its board must ensure disclosure and transparency concerning the company's true financial performance as well as its governance practices. Accounting games may be short-term fixes, but they are not long-term bases for financial credibility.

Our recommendations, therefore, build on these two essentials: first, an audit committee with actual practices and overall performance that reflect the professionalism embodied by the full board of which it is a part, and second, a legal, regulatory, and self-regulatory framework that emphasizes disclosure and transparency and accountability.

The Committee wishes to stress that while the recommendations in this Report appear separately, they together form a mosaic to enhance financial reporting and oversight of that process; in this light, the Committee views the recommendations as an integrated set of objectives that must be adopted in its entirety in order to accomplish the intended results. The need for such an integrated approach is of even greater importance given the fact that implementation will require action by a number of entities including the Securities and Exchange Commission (SEC), the securities markets through the self-regulatory organizations (SROs), the accounting profession, and, of course, boards and audit committees.

Notably, while several of the recommendations that apply to public companies contemplate an exemption for smaller entities due to the burdens involved, the Committee urges all companies regardless of size to make a good faith attempt to follow these recommendations. Similarly, while a number of the recommendations propose amendments to the listing standards applied by the NYSE and the NASD, the Committee

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hopes that these proposed amendments to listing standards be considered by any market that is a primary venue for U.S. equities.

It is with these perspectives the Committee advances the recommendations outlined in summary form below. The section of this Report, entitled “The Audit Committee as Catalyst for Effective Financial Reporting,” more fully describes the rationale and intentions underlying each of these recommendations.

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## Summary

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The first two recommendations are aimed at strengthening the independence of the audit committee:

### Recommendation 1

The Committee recommends that both the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) adopt the following definition of independence for purposes of service on the audit committee for listed companies with a market capitalization above \$200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD):

Members of the audit committee shall be considered independent if they have no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation. Examples of such relationships include:

- a director being employed by the corporation or any of its affiliates for the current year or any of the past five years;
- a director accepting any compensation from the corporation or any of its affiliates other than compensation for board service or benefits under a tax-qualified retirement plan;
- a director being a member of the immediate family of an individual who is, or has been in any of the past five years, employed by the corporation or any of its affiliates as an executive officer;
- a director being a partner in, or a controlling shareholder or an executive officer of, any for-profit business organization

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to which the corporation made, or from which the corporation received, payments that are or have been significant\* to the corporation or business organization in any of the past five years;

- a director being employed as an executive of another company where any of the corporation's executives serves on that company's compensation committee.

A director who has one or more of these relationships may be appointed to the audit committee, if the board, under exceptional and limited circumstances, determines that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, and the board discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.

## Recommendation 2

The Committee recommends that in addition to adopting and complying with the definition of independence set forth above for purposes of service on the audit committee, the NYSE and the NASD require that listed companies with a market capitalization above \$200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD) have an audit committee comprised solely of independent directors.

The Committee recommends that the NYSE and the NASD maintain their respective current audit committee independence requirements as well as their respective definitions of

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\* The Committee views the term "significant" in the spirit of Section 1.34(a)(4) of the American Law Institute Principles of Corporate Governance and the accompanying commentary to that section.

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independence for listed companies with a market capitalization of \$200 million or below (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD).

Our second set of recommendations is aimed at making the audit committee more effective:

### Recommendation 3

The Committee recommends that the NYSE and the NASD require listed companies with a market capitalization above \$200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD) to have an audit committee comprised of a minimum of three directors, each of whom is financially literate (as described in the section of this report entitled “Financial Literacy”) or becomes financially literate within a reasonable period of time after his or her appointment to the audit committee, and further that at least one member of the audit committee have accounting or related financial management expertise.

The Committee recommends that the NYSE and the NASD maintain their respective current audit committee size and membership requirements for companies with a market capitalization of \$200 million or below (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD).

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## Recommendation 4

The Committee recommends that the NYSE and the NASD require the audit committee of each listed company to (i) adopt a formal written charter that is approved by the full board of directors and that specifies the scope of the committee's responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements, and (ii) review and reassess the adequacy of the audit committee charter on an annual basis.

## Recommendation 5

The Committee recommends that the Securities and Exchange Commission (SEC) promulgate rules that require the audit committee for each reporting company to disclose in the company's proxy statement for its annual meeting of shareholders whether the audit committee has adopted a formal written charter, and, if so, whether the audit committee satisfied its responsibilities during the prior year in compliance with its charter, which charter shall be disclosed at least triennially in the annual report to shareholders or proxy statement and in the next annual report to shareholders or proxy statement after any significant amendment to that charter.

The Committee further recommends that the SEC adopt a "safe harbor" applicable to all disclosure referenced in this Recommendation 5.

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Our final group of recommendations addresses mechanisms for accountability among the audit committee, the outside auditors, and management:

### Recommendation 6

The Committee recommends that the listing rules for both the NYSE and the NASD require that the audit committee charter for every listed company specify that the outside auditor is ultimately accountable to the board of directors and the audit committee, as representatives of shareholders, and that these shareholder representatives have the ultimate authority and responsibility to select, evaluate, and, where appropriate, replace the outside auditor (or to nominate the outside auditor to be proposed for shareholder approval in any proxy statement).

### Recommendation 7

The Committee recommends that the listing rules for both the NYSE and the NASD require that the audit committee charter for every listed company specify that the audit committee is responsible for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, consistent with Independence Standards Board Standard 1, and that the audit committee is also responsible for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to ensure the independence of the outside auditor.

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## Recommendation 8

The Committee recommends that Generally Accepted Auditing Standards (GAAS) require that a company's outside auditor discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting; the discussion should include such issues as the clarity of the company's financial disclosures and degree of aggressiveness or conservatism of the company's accounting principles and underlying estimates and other significant decisions made by management in preparing the financial disclosure and reviewed by the outside auditors. This requirement should be written in a way to encourage open, frank discussion and to avoid boilerplate.

## Recommendation 9

The Committee recommends that the SEC require all reporting companies to include a letter from the audit committee in the company's annual report to shareholders and Form 10-K Annual Report disclosing whether or not, with respect to the prior fiscal year: (i) management has reviewed the audited financial statements with the audit committee, including a discussion of the quality of the accounting principles as applied and significant judgments affecting the company's financial statements; (ii) the outside auditors have discussed with the audit committee the outside auditors' judgments of the quality of those principles as applied and judgments referenced in (i) above under the circumstances; (iii) the members of the audit committee have discussed among themselves, without management or the outside auditors present, the information disclosed to the audit committee described in (i) and (ii) above; and (iv)

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the audit committee, in reliance on the review and discussions conducted with management and the outside auditors pursuant to (i) and (ii) above, believes that the company's financial statements are fairly presented in conformity with Generally Accepted Accounting Principles (GAAP) in all material respects.

The Committee further recommends that the SEC adopt a "safe harbor" applicable to any disclosure referenced in this Recommendation 9.

## Recommendation 10

The Committee recommends that the SEC require that a reporting company's outside auditor conduct a SAS 71 Interim Financial Review prior to the company's filing of its Form 10-Q.

The Committee further recommends that SAS 71 be amended to require that a reporting company's outside auditor discuss with the audit committee, or at least its chairman, and a representative of financial management, in person, or by telephone conference call, the matters described in AU Section 380, Communications With the Audit Committee, prior to the filing of the Form 10-Q (and preferably prior to any public announcement of financial results), including significant adjustments, management judgments and accounting estimates, significant new accounting policies, and disagreements with management.



## The Case for Timely and Practical Action

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The corporate governance debate has changed dramatically over the last three decades, moving from fundamental arguments over its relevance, to a practical discussion (which assumes relevance) of how to transform the concept from a good idea on paper to a reality in practice. One of the issues that has taken on increasing importance in the search for good governance is how best to harness the oversight process to achieve more fully the goal of quality corporate financial reporting. This important search leads immediately to the audit committee of the board of directors -- the entity at the core of the corporate financial reporting process.

In recent years, there has been an increasing sense of urgency surrounding the need for responsible financial reporting given the market's increasing focus on corporate earnings and a long and powerful bull market. At the same time, the demands on the flexibility of our financial reporting have become increasingly intense -- with the growing sophistication of complex financial instruments to manage risks, the use of corporate restructurings to stay abreast of the latest business trends, and the emergence of new industries based on technology and information. The recent turmoil in foreign markets has further compounded pressures on financial reporting.

Navigating these uncharted waters requires great skill, and sometimes the temptation not to disappoint proves too great. The Chairman of the SEC, Arthur Levitt, at a recent address at New York University on the present state of financial reporting, expressed his "fear [that] we are witnessing a gradual, but noticeable erosion in the quality of financial reporting," and the emergence of a "grey area . . . where accounting

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practices are perverted; where managers cut corners; where earnings reports reflect the desires of management rather than underlying financial performance of the company.”

There is little question, in the Committee’s view, that some companies do respond to analysts and short-term market pressures by “managing” their earnings. While earnings management is not necessarily inappropriate, it can become abusive when it obscures the true financial performance of the company.

In that same address, SEC Chairman Levitt also referred to a number of highly publicized reports of companies practicing inappropriate earnings management in order to meet analysts’ forecasts and to deliberately smooth earnings. Some of the specific practices referred to include:

- deliberately overstating one-time “big bath” restructuring charges in order to provide a cushion to satisfy future Wall Street earnings estimates;
- the misuse of acquisition accounting, particularly improper write-offs of acquired in-process research development, to inappropriately overstate future earnings;
- “cookie jar reserves” where companies over-accrue charges for such items as sales returns, loans losses or warranty costs in good times and use those reserves to smooth future earnings in bad times;
- premature revenue recognition, before a sale is complete, before a product is delivered to a customer, or at a time when the customer still has options to terminate, void or delay the sale;
- improper deferral of expenses to improve reported results; and
- misuse of the concept of materiality to mask inappropriate accounting treatment.

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The Committee believes practices such as those described above can distort a company's true financial condition and results of operations, thus providing a compelling impetus for the Committee's task of improving oversight of the financial reporting system through the audit committee. Such practices, if left unchecked, have the potential to undermine investor confidence in the integrity of our securities markets.

Accordingly, the Committee calls for strengthening the role of the audit committee with pragmatic, progressive recommendations that can be quickly implemented. If these recommendations are implemented, the Committee believes audit committees will be more effective in helping to ensure the transparency and integrity of financial reporting and, thereby, maintain the investor confidence that makes our securities markets the deepest and most liquid in the world.

We leave it to other qualified bodies to debate and study thoroughly the proper technical accounting measures and the myriad other relevant issues that arise in this domain. In addition, the audit committee, if properly functioning and advised, can deal with the technical issues as they arise in a manner tailored to the individual company. Here, we focus on the broad oversight process, because even the finest set of rules will be no better than the oversight process designed to oversee them.

Improving oversight of the financial reporting process necessarily involves the imposition of certain burdens and costs on public companies. Despite these costs, the Committee believes that a more transparent and reliable financial reporting process ultimately results in a more efficient allocation of and lower cost of capital. To the extent that instances of outright fraud, as well as other practices that result in lower quality financial reporting, are reduced with improved oversight, the benefits clearly justify these expenditures of resources.

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## **T**he Audit Committee as Catalyst for Effective Financial Reporting

Good governance promotes relationships of accountability among the primary corporate participants to enhance corporate performance. It holds management accountable to the board and the board accountable to shareholders. In this paradigm, the board is in place to ensure that management is working in the best interests of the corporation and its shareholders -- by working to enhance corporate economic value. The audit committee's role flows directly from the board oversight function.

A key element of board oversight is working with management to achieve corporate legal and ethical compliance. Such oversight includes ensuring that quality accounting policies, internal controls, and independent and objective outside auditors are in place to deter fraud, anticipate financial risks and promote accurate, high quality and timely disclosure of financial and other material information to the board, to the public markets, and to shareholders.

This oversight function is typically delegated by the full board to the audit committee, pursuant to the board's general ability under state law to delegate certain of its duties to committees. While the listing standards of the primary U.S. securities exchanges mandate that companies have an audit committee, these listing standards do not stipulate with much specificity how an audit committee should be comprised and, moreover, how it should function. Similarly, neither state corporate law nor federal securities law lend much guidance on audit committee structure or role.

A significant body of literature concerning corporate governance has evolved over the past two decades guiding boards in their composi-

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tion, structure, and responsibilities, as referenced in the Bibliography to this Report. The Committee believes that the same progressive governance standards applicable to the full board should be used to decide how the audit committee should carry out its job, and who should serve on the audit committee.

## Audit Committee Membership

Good governance dictates that the board be comprised of individuals with certain personal characteristics, such as a recognition of the importance of the board's tasks, integrity, a sense of accountability, a history of achievement, and the ability to ask tough questions. Directors also should possess certain core competencies -- such as financial literacy, experience with organizations, leadership, and strategic thinking. Directors must have a significant degree of commitment to the company and its board -- such that they have adequate time for meeting preparation, near perfect meeting attendance, and ongoing education as to the company's business and environment and topical issues. As a whole, the board should have individual directors who contribute special expertise relevant to the company, such as manufacturing, marketing, financial, accounting, and international or other appropriate experience. Most importantly, the board overall should consist of a majority of independent directors.

It follows that as a member of the full board each member of the audit committee should possess most of the characteristics and core competencies enumerated above. The Committee views certain of these attributes as particularly important for audit committee membership -- namely, recognition of the significance of the audit committee's responsibilities, time commitment, financial literacy, and, above all, independence.

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## Independence

The rationale supporting the call for a majority of independent directors on a board of directors -- that independence is critical to ensuring that the board fulfills its objective oversight role and holds management accountable to shareholders -- is especially applicable to the audit committee. In fact, it is widely recognized that each member of the audit committee should be an independent director. Several recent studies have produced a correlation between audit committee independence and two desirable outcomes: a higher degree of active oversight and a lower incidence of financial statement fraud. In addition, common sense dictates that a director without any financial, family, or other material personal ties to management is more likely to be able to evaluate objectively the propriety of management's accounting, internal control and reporting practices.

The NYSE requires listed companies to have at least a two-member audit committee composed of all independent directors. The NYSE Listed Company Manual characterizes independent directors as those who are "free from any relationship that, in the opinion of the Board of Directors, would interfere with the exercise of independent judgment as a committee member." Section 303.00 specifies that directors who are "affiliates" of the company, or officers or employees of the company or of its subsidiaries, are not considered independent. Former officers of the company and its subsidiaries, however, may qualify for audit committee membership despite continued pension or deferred compensation from the company if "in the opinion of the Board of Directors, such person will exercise independent judgment and will materially assist the function of the committee." Former com-

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pany officers, however, cannot comprise the majority of the committee.

Rule 4460 of the Marketplace Rules of the NASD requires that an issuer maintain an audit committee comprised of a majority of independent directors. Rule 4200(a)(13) defines an “independent” director as a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship that, in the opinion of the board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director.

The Committee believes that the current NYSE and NASD standards on independence allow for too much discretion and should be fortified. Certain relationships can impair a director’s independent judgment and therefore should automatically disqualify a director from being considered “independent.”

The Committee also recognizes, however, that smaller companies may have greater difficulties meeting any enhanced standard regarding independence; companies with smaller market capitalizations -- so-called “small-cap” companies -- may have relationships with large investors that may require greater flexibility as to board and audit committee membership and composition.

## Recommendation 1

The Committee recommends that both the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) adopt the following definition of independence for purposes of service on the audit committee for listed companies with a market capitalization above \$200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD):

Members of the audit committee shall be considered independent if they have no relationship to the corporation that may interfere with the exercise of their independence from management and the corporation. Examples of such relationships include:

- a director being employed by the corporation or any of its affiliates for the current year or any of the past five years;
- a director accepting any compensation from the corporation or any of its affiliates other than compensation for board service or benefits under a tax-qualified retirement plan;
- a director being a member of the immediate family of an individual who is, or has been in any of the past five years, employed by the corporation or any of its affiliates as an executive officer;
- a director being a partner in, or a controlling shareholder or an executive officer of, any for-profit business organization to which the corporation made, or from which the corporation received, payments that are or have been significant\* to the corporation or business organization in any of the past five years;
- a director being employed as an executive of another company where any of the corporation's executives serves that company's compensation committee.

A director who has one or more of these relationships may be appointed to the audit committee, if the board, under exceptional and limited circumstances, determines that membership on the committee by the individual is required by the best interests of the corporation and its shareholders, and the board discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination.

\* The Committee views the term "significant" in the spirit of Section 1.34(a)(4) of the American Law Institute Principles of Corporate Governance and the accompanying commentary to that section.

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## Recommendation 2

The Committee recommends that in addition to adopting and complying with the definition of independence set forth above for purposes of service on the audit committee, the NYSE and the NASD require that listed companies with a market capitalization above \$200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD) have an audit committee comprised solely of independent directors.

The Committee recommends that the NYSE and the NASD maintain their respective current audit committee independence requirements as well as their respective definitions of independence for listed companies with a market capitalization of \$200 million or below (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD).

### Financial Literacy

A well-balanced and effective board should, as noted above, have directors with an array of talent, experience, and expertise which bear on different aspects of the company's activities; such diverse contributions are often made by different directors. Because of the audit committee's responsibility for overseeing the corporate accounting and financial controls and reporting, however, this committee clearly has a more recognizable need for members with accounting and/or related financial expertise -- where "expertise" signifies 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 CEO or other senior officer with financial oversight responsibilities.

While all members of the audit committee must have the ability to ask probing questions about the corporation's financial risks and accounting, the Committee recognizes that a director's ability to ask and intelligently evaluate the answers to such questions may not require "expertise" but rather hinges on intelligence, diligence, a probing mind,

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and a certain basic “financial literacy.” Such “literacy” signifies the ability to read and understand fundamental financial statements, including a company’s balance sheet, income statement, and cash flow statement. Directors who have limited familiarity with finance can achieve such “literacy” through company-sponsored training programs.

Because of the audit committee’s responsibilities and the complex nature of the accounting and financial matters reviewed, the committee merits significant director resources, both in terms of the number of directors dedicated to the committee and the time each director devotes to committee matters.

### Recommendation 3

The Committee recommends that the NYSE and the NASD require listed companies with a market capitalization above \$200 million (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD) to have an audit committee comprised of a minimum of three directors, each of whom is financially literate (as described in the section of this Report entitled “Financial Literacy”) or becomes financially literate within a reasonable period of time after his or her appointment to the audit committee, and further that at least one member of the audit committee have accounting or related financial management expertise.

The Committee recommends that the NYSE and the NASD maintain their respective current audit committee size and membership requirements for companies with a market capitalization of \$200 million or below (or a more appropriate measure for identifying smaller-sized companies as determined jointly by the NYSE and the NASD).

## Audit Committee Structure and Process

A key attribute of a good board is its own diligence in defining the board’s role, responsibilities, structure, and processes. An effective board is self-aware and determines how best to carry out its important tasks. Likewise, a well-functioning audit committee will be concerned about and spend a significant amount of time defining the scope of its over-

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sight responsibilities and how it discharges its duties. Just as good boards often adopt formal guidelines on how they should operate, a good audit committee should memorialize its understanding of its role, responsibilities, and processes in a charter. In focusing its activities on oversight of the entire reporting process, the committee will be more likely to recognize those duties better left to management, including the internal auditor, and the outside auditors.

Further, the audit committee should disclose its self-determined role, structure, and practices. Such transparency is at the heart of good governance, serves to inform investors, and also acts as a disciplinary measure on the committee. It will encourage committees to think about their important role, to articulate a clear mission, and then to establish appropriate practices and follow them. Disclosure will guide the committee to responsible practices, as sunlight generally does. It is not the Committee's intention or belief that such additional disclosure requirements would impose greater liability on the audit committee or full board under state law. Rather the current standards for liability under the business judgment rule -- in essence, gross negligence -- would continue to apply.

While such a "safe harbor" presumably exists in the context of a state-law fiduciary duty claim, the Committee believes that the SEC should adopt a safe harbor under the federal securities laws similar to the one now applicable to the executive compensation committee's report which appears in the proxy statement.

Importantly, the Committee does not recommend mandating every detail to be included in the guidelines for every audit committee. There are too many variables amongst the multitude of different corporations

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comprising our economy. The Committee recommends that every audit committee consider the contents of the section of this Report entitled “Guiding Principles for Audit Committee Best Practices,” which is designed to guide the development of the substantive content of an audit committee charter. We also encourage audit committees to refer to the sample charters included in Appendix C and the publications included in the Bibliography to this Report as a starting point for best practices to be considered. Ultimately, the market will be the judge of whether each committee’s disclosed guidelines are adequate.

#### Recommendation 4

The Committee recommends that the NYSE and the NASD require the audit committee of each listed company to (i) adopt a formal written charter that is approved by the full board of directors and that specifies the scope of the committee’s responsibilities, and how it carries out those responsibilities, including structure, processes, and membership requirements, and (ii) review and reassess the adequacy of the audit committee charter on an annual basis.

#### Recommendation 5

The Committee recommends that the Securities and Exchange Commission (SEC) promulgate rules that require the audit committee for each reporting company to disclose in the company’s proxy statement for its annual meeting of shareholders whether the audit committee has adopted a formal written charter, and, if so, whether the audit committee satisfied its responsibilities during the prior year in compliance with its charter, which charter shall be disclosed at least triennially in the annual report to shareholders or proxy statement and in the next annual report to shareholders or proxy statement after any significant amendment to that charter.

The Committee further recommends that the SEC adopt a “safe harbor” applicable to all disclosure referenced in this Recommendation 5.

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## Audit Committee Relationships with Management, including the Internal Auditor, and with the Outside Auditors

Management including the internal auditor, the full board including the audit committee, and the outside auditors, all have a distinct role in corporate accounting and financial reporting. All of these actors must work together fluidly to effectuate an objective and responsible system. In this system, management is principally responsible for company accounting policies and the preparation of the financial statements. The outside auditor is responsible for auditing and attesting to the company's financial statements and evaluating the company's system of internal controls. The audit committee, as the delegate of the full board, is responsible for overseeing the entire process. In those companies with an internal audit function, the internal auditor also plays a significant role in working with management, the outside auditor, and the audit committee in ensuring the effectiveness of internal controls and in bringing any weaknesses to the attention of the appropriate parties.

In light of these interrelated functions, it is important to delineate the nature of the relationships among these actors -- specifically the "direction" of certain reporting relationships and tiers of accountability among them.

In particular, the relationship of the outside auditor with each of management and the audit committee must be clarified. As noted in the 1994 POB Report "[i]n most companies today, management selects or recommends auditors and changes in auditors, negotiates fees, selects accounting principles, makes estimates, prepares the financial statements and monitors the audit." Consequently, the outside auditors typically develop over time close relationships with management. Indeed, by

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virtue of their responsibility for everyday operations, senior managers need to interact closely with the outside auditors over issues arising in the financial reporting process. Additionally, the expanding role of outside auditors, particularly in providing non-audit services, has further entwined the relationship of management and the outside auditors.

It is therefore imperative to the integrity and effectiveness of the audit committee oversight process that all parties recognize that the audit committee and full board, as the representatives of shareholders, are the ultimate entities to which the auditors are accountable. As such, the audit committee has the responsibility to review regularly the relationship between management and the outside and internal auditors.

Since audit committees are members of the board of directors with enhanced responsibility for overseeing a company's financial reporting, they serve, as SEC Chairman Levitt has noted, as the "primary link" between a board and its outside auditors. To make this relationship effective, the committee and the outside auditors must develop a direct, strong and candid relationship. That is to say that the lines of communication and reporting should facilitate independence from management and encourage the outside auditors and the internal auditors to speak freely, regularly and on a confidential basis with the audit committee.

Moreover, because the outside auditor is responsible for attesting to the fair presentation of the financial statements, its reputation for objectivity must not be compromised. In recognition of this, the Independence Standards Board (ISB) recently adopted a new Standard mandating that the outside auditor of a public company: (i) disclose in writing to the company's audit committee all relationships with the company that could affect the auditor's independence; (ii) confirm its

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view that it is independent of the company; and (iii) discuss such matters with the audit committee. The Committee recognizes that this disclosure and discussion is a two-way street: to ensure a useful examination of the objectivity of the outside auditor, the audit committee must be an active participant in this process.

### Recommendation 6

The Committee recommends that the listing rules for both the NYSE and the NASD require that the audit committee charter for every listed company specify that the outside auditor is ultimately accountable to the board of directors and the audit committee, as representatives of shareholders, and that these shareholder representatives have the ultimate authority and responsibility to select, evaluate, and, where appropriate, replace the outside auditor (or to nominate the outside auditor to be proposed for shareholder approval in any proxy statement).

### Recommendation 7

The Committee recommends that the listing rules for both the NYSE and the NASD require that the audit committee charter for every listed company specify that the audit committee is responsible for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the company, consistent with Independence Standards Board Standard 1, and that the audit committee is also responsible for actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services which may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to ensure the independence of the outside auditor.

## Practical Improvements to Audit Committee Oversight

To facilitate audit committee oversight of the financial reporting process and deepen the audit committee's probing of the relevant issues, the Committee believes that both the outside auditor and the audit committee should have greater affirmative disclosure requirements -- to each other and, when appropriate, to the public.

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## Enhancing the Outside Auditors' Communication with the Audit Committee

The audit committee is dependent on both management and the outside auditors for a full range of information -- based in both fact and judgments -- regarding the financial reporting process. Under the current auditing standards, the outside auditor is required to communicate certain information to the audit committee, including matters such as disagreements with management, consultations with other accountants, and difficulties encountered in performing the audit such as unreasonable delays by management or unavailability of client personnel. In addition, the auditor is required to report to the audit committee "reportable conditions," which are deficiencies that could adversely affect the company's ability to produce reliable financial statements. Further, the outside auditor may be required to report illegal acts detected during the audit to management and the audit committee.

While all this information serves as a concrete basis upon which the audit committee evaluates a company's compliance with financial reporting requirements, it may too often be distilled into a standardized "form" letter. In addition, such information offers little guidance on the more subjective judgments that arise in the ordinary course of financial reporting. In preparing a company's financial statements, judgments are made concerning estimates, elective accounting principles and new significant transactions. The Committee believes that many concerns about the "quality" of financial reporting can be attributed to a failure to question such significant subjective judgments. These judgments can have a significant impact on how the financial statements are presented, and the Committee believes that the audit

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committee should be positioned to adequately assess their influence on the company's financial reports.

### Recommendation 8

The Committee recommends that Generally Accepted Auditing Standards (GAAS) require that a company's outside auditor discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the company's accounting principles as applied in its financial reporting; the discussion should include such issues as the clarity of the company's financial disclosures and degree of aggressiveness or conservatism of the company's accounting principles and underlying estimates and other significant decisions made by management in preparing the financial disclosure and reviewed by the outside auditors. This requirement should be written in a way to encourage open, frank discussion and to avoid boilerplate.

### Instituting Audit Committee Disclosure

Disclosure and transparency form a cornerstone of corporate governance, enabling shareholders to make informed decisions about their investments and the performance of those parties managing company assets and representing their interests. Past groups that have studied ways to improve the financial reporting process have differed over the value of requiring audit committees to disclose specified information about their activities. In recommending implementation of a disclosure requirement, the Treadway Report noted that this action could "reinforce the audit committee's awareness and acceptance of their responsibilities." By comparison, the 1994 POB Report expressed concern that this additional disclosure could become "lengthy 'boilerplate' that does not get to the heart of the underlying issue."

Past experience supports both these views. After the SEC imposed disclosure requirements on those committees that establish executive compensation, for instance, there were numerous reports of increased director awareness of the important role compensation plays in provid-

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ing the proper incentives for management performance. However, many of these well-meaning disclosure requirements over time have fallen prey to well-parsed language that is nearly identical from one filing to the next.

Based on these and other examples and the feedback provided through its hearings and invitation to comment, the Committee supports a “middle ground” approach between the Treadway Report’s recommendation for a full fledged report and the 1994 POB Report’s rejection of imposing a meaningless disclosure requirement.

General disclosure about the audit committee’s review of the entire audit process -- from management’s and the internal auditor’s accounting practices to the outside auditor’s audit of the company’s financial statements -- will highlight that the audit committee is in place to assure shareholders that procedures that promote accountability are integrated into the roles and practices of all the other relevant players. A formal disclosure by the audit committee as to its view of the company’s financial statements that is consistent with the board’s existing duty to sign the Form 10-K, will serve to raise public awareness of the importance of the audit committee’s role as well as underscore its importance for audit committee members. The Committee appreciates the impracticability of having the audit committee do more than rely upon information it receives, questions, and assesses in making this disclosure.

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## Recommendation 9

The Committee recommends that the SEC require all reporting companies to include a letter from the audit committee in the company's annual report to shareholders and Form 10-K Annual Report disclosing whether or not, with respect to the prior fiscal year: (i) management has reviewed the audited financial statements with the audit committee, including a discussion of the quality of the accounting principles as applied and significant judgments affecting the company's financial statements; (ii) the outside auditors have discussed with the audit committee the outside auditors' judgments of the quality of those principles as applied and judgments referenced in (i) above under the circumstances; (iii) the members of the audit committee have discussed among themselves, without management or the outside auditors present, the information disclosed to the audit committee described in (i) and (ii) above; and (iv) the audit committee, in reliance on the review and discussions conducted with management and the outside auditors pursuant to (i) and (ii) above, believes that the company's financial statements are fairly presented in conformity with Generally Accepted Accounting Principles (GAAP) in all material respects.

The Committee further recommends that the SEC adopt a "safe harbor" applicable to any disclosure referenced in this Recommendation 9.

### **Mandating Auditor Interim Financial Review**

The Committee acknowledges the pressures on companies to meet or beat Wall Street earnings projections and the important role of interim reporting to a company's market performance. Currently, companies can have their outside auditors limit their review of such financial statements to the end of the year before the annual report is filed with the SEC. This practice has led to "adjustments" at year end for inaccuracies not detected during the preceding three quarters. The Committee believes that increased involvement by the outside auditors and the audit committee in the interim financial reporting process should result in more accurate interim reporting. Recognizing the importance of these reviews, each of the Big Five accounting firms recently required their clients to implement such procedures as a condition to their audit engagement.

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An increased level of monitoring of the interim reporting process can be achieved by requiring regular interim communications by the outside auditor with financial management and the audit committee. Of course, the outside auditors' ability to fulfill such a requirement would be dependent on the cooperation and availability of financial management and the audit committee. The Committee fully expects that financial management and the audit committee would engender the appropriate diligence, initiative and commitment to participate in such communications.

### Recommendation 10

The Committee recommends that the SEC require that a reporting company's outside auditor conduct a SAS 71 Interim Financial Review prior to the company's filing of its Form 10-Q.

The Committee further recommends that SAS 71 be amended to require that a reporting company's outside auditor discuss with the audit committee, or at least its chairman, and a representative of financial management, in person, or by telephone conference call, the matters described in AU Section 380, Communications With the Audit Committee, prior to the filing of the Form 10-Q (and preferably prior to any public announcement of financial results), including significant adjustments, management judgments and accounting estimates, significant new accounting policies and disagreements with management.



## Guiding Principles for Audit Committee Best Practices

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As we noted at the outset of this Report, the Committee believes that the proper functioning of an audit committee relies first on the entire board, and then specifically on the audit committee members' attitude toward their own role. If an audit committee is determined to be diligent in its oversight role, a sure sense of appropriate action will follow; credible diligence is not rocket science. In fact, the specifics of how any audit committee conducts its business should be self-determined. Since each company has its own unique circumstances -- type of business, industry, competitive environment, stage in the business cycle and business risks -- audit committee practices will vary naturally. By recognizing the need for this variance, and by capturing it in uniquely appropriate policies, audit committee members go a long way toward fulfilling their responsibilities. This process, in turn, is an excellent discipline for the audit committee.

Therefore, in lieu of specifying a litany of best practices to which every audit committee should adhere, the Committee outlines "Guiding Principles" for best practices -- a catalog of common sense fundamentals that apply regardless of an individual company's situation. The Committee intends the following Principles to serve as building blocks for devising company-specific processes and practices, and ultimately for the committee's charter. Again, we encourage audit committee members to study the various more detailed recommendations contained in the publications referenced in Appendix C and the Bibliography to this Report.

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## Principle 1: The Audit Committee's Key Role in Monitoring the Other Component Parts of the Audit Process

In its oversight capacity, the audit committee is neither intended nor equipped to guarantee with certainty to the full board and shareholders the accuracy and quality of a company's financial statements and accounting practices. Proper financial reporting, accounting, and audit functions are collaborative efforts conducted by full-time professionals dedicated to these purposes. The audit committee, as the first among equals, oversees the work of the other actors in the financial reporting process -- management, including the internal auditor, and the outside auditors -- to endorse the processes and safeguards employed by each. In particular, the audit committee should encourage procedures that promote accountability among these players, ensuring that management properly develops and adheres to a sound system of internal control, that the internal auditor objectively assesses management's accounting practices and internal controls, and that the outside auditors, through their own review, assess management and the internal auditor's practices.

The audit committee should seek to affirm the existence of these nexuses of accountability by learning the roles and responsibilities of each of these participants. These roles and responsibilities should be commonly understood and agreed to by each of the other participants in the process -- preferably in writing.

From this basic understanding of the relevant roles and responsibilities of each participant in the process, the audit committee will be in a position to devise appropriate questions as to how each participant carries out its functions. These questions should not be merely a "check-

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list” of standard questions to be asked each year, but should be tailored to a company’s particular circumstances. (See Principle 4 below.)

## **Principle 2: Independent Communication and Information Flow between the Audit Committee and the Internal Auditor.**

The Committee recognizes that responsible financial reporting is derived in large part from an effective system of internal controls. While management is responsible for internal controls, the internal auditor is in a position to evaluate and report on the adequacy and effectiveness of those controls.

The internal auditor occupies a unique position -- he or she is “employed” by management, but is also expected to review the conduct of management. This can create significant tension since the internal auditor’s “independence” from management is necessary for the auditor to objectively assess management’s actions, but the auditor’s “dependence” on management for employment is clear. Recognizing this tension, the Committee believes that it is essential to have formal mechanisms in place to facilitate confidential exchanges between the internal auditor and the audit committee. These mechanisms may take the form of regular meetings independent of management, or regular confidential memos or reports circulated only to the audit committee. If such meetings or correspondence are regularly scheduled regardless of the identification of irregularities or problems, independent dialogue between the audit committee and the internal auditor should lose its “taboo” nature and no longer imply treason against management.

The audit committee must establish and support a culture that promotes open disclosure on the part of the internal auditor and a recogni-

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tion that if the internal auditor identifies a problem and cannot obtain the support of management, that he or she has a duty to the audit committee, the full board, and shareholders to disclose the relevant information to the audit committee. Management should more than acquiesce in this duty to disclose; management should encourage and support such disclosure by word and deed.

### **Principle 3: Independent Communication and Information Flow between the Audit Committee and the Outside Auditors**

If the audit committee is to effectively accomplish its task of overseeing the financial reporting process, it must rely, in part, on the work, guidance and judgment of the outside auditor. Integral to this reliance is the requirement that the outside auditors perform their service without being affected by economic or other interests that would call into question their objectivity and, accordingly, the reliability of their attestation. Consistent with Recommendation 7 of this Report (which suggests that the listing rules require listed companies to formally disclose information about audit committee and outside auditor communications regarding auditor independence), the Committee believes that every audit committee should adopt additional voluntary measures to ensure outside auditors' objectivity.

As with the internal auditor, the audit committee should develop regularly scheduled meetings and/or reports with the outside auditors independent of management. Only through open, regular, frank, and confidential dialogue will the audit committee be in a position to utilize the knowledge of the outside auditors in assessing internal controls, management, the internal auditor, and the impact of each on the quality

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and reliability of the financial statements. In addition, the committee should promote a culture that values objective and critical analysis of management and the internal auditor. In this regard, the audit committee should ensure that the outside auditors have provided the committee with the information that would be required to be disclosed by GAAS, including the topics covered by SAS 54, 60, 61, and 82. The Committee should ask searching questions regarding this information, not simply accept a “report.” (See Principle 4 below.)

#### **Principle 4: Candid Discussions With Management, the Internal Auditor, and Outside Auditors Regarding Issues Implicating Judgment and Impacting Quality**

Since the audit committee is largely dependent on the information provided to it by management, the internal auditor, and the outside auditors, it is imperative that the committee cultivate frank dialogue with each as outlined in Principles 2 and 3 above. As Harvard Business School Professor Joseph Hinsey stated at an open hearing held by this Committee, this dialogue should provide the audit committee with insights into the “whats and whys” behind the numbers and the process.

Given management’s lead role, the committee will normally work closely with and rely upon the senior executives of the company, especially those executives representing financial management -- the chief financial officer, the treasurer, and the controller. Management typically will apprise the committee of the overall business environment and risks, and its system for internal controls, and provide an explanation of the company’s financial statements. In particular, management should provide the audit committee with:

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- timely, periodic reviews of the financial statements and related disclosure documents prior to filing with the SEC;
  - presentations concerning: any changes in accounting principles or financial reporting policies from a prior year; the accounting treatment accorded significant transactions; and any significant variations between budgeted and actual numbers in a particular account;
  - information regarding any “second” opinions sought by management from an outside auditor with respect to the accounting treatment of a particular event or transaction; and
  - management’s response to the assessments provided by the internal and outside auditor.

Once this basic financial knowledge has been imparted, the committee then should look to the internal auditor and the outside auditors to verify management’s compliance with process and procedures and seek additional input on any significant judgments made. The audit committee should engage the internal auditor and the outside auditors in a dialogue and set up other mechanisms to ensure that the committee has received all the necessary and pertinent information. For instance, when circumstances dictate, management should help the audit committee retain independent legal counsel and/or financial advisors.

Additional mechanisms to support the audit committee may include a checklist of questions to review with management, the internal auditor, and the outside auditors. Such questions may cover:

- the accounting implications of new, significant transactions;
- changes in, or the continued propriety of, elective accounting principles;
- the methods of application of such principles and their aggressiveness or conservatism;

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- the use of reserves and accruals;
  - significant estimates and judgments used in the preparation of the financial statements;
  - internal and outside auditors' methods for risk assessments and the results of those assessments;
  - changes in the scope of the audit as a result of such risk assessments;
  - the emergence or elimination of high risk areas;
  - the effect of any external environmental factors (economic, industrial or otherwise) on financial reporting and the audit process; and/or
  - any other questions addressing topics that the audit committee believes may influence the quality of the financial statements, including any other issues the outside auditor must address under GAAS. (See Recommendations 8 and 9 and Principle 3 above.)

Audit committees, however, are cautioned against using such a checklist of recommended questions as a substitute for conducting their own investigation and analysis.

### **Principle 5: Diligent and Knowledgeable Audit Committee Membership**

Consistent with Recommendations 2 and 3 of this Report, which urge qualification requirements regarding independence and financial literacy for all audit committee members, the Committee expects that audit committees will carefully consider further qualifications for those who serve on the committee. Importantly, the board of directors should have mechanisms that encourage selection and retention of diligent and knowledgeable members who are dedicated to and interested in the job

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and willing to devote a substantial commitment of time and energy to the responsibilities of the audit committee in addition to board responsibilities.

Such mechanisms might include distributing to nominees to the committee a written description of qualifications, diligence, and time commitment the board expects of members, as well as a clear statement of the expectation that audit committee members will recognize the seriousness of the committee's purpose and will fulfill their duties accordingly. In recognition of the additional time commitment necessary, the full board may decide that audit committee service merits higher compensation than service on other board committees.

The audit committee should also consider training and education programs to ensure that its membership has the proper background and knowledge base and stays current as to relevant developments in accounting and finance. To determine their educational needs, members must analyze their weaknesses and may ask management, the internal auditor and the outside auditors their views on members' gaps in knowledge or "know-how." Training may be conducted by professionals within the company, but the committee should also have the ability to engage outside advisors for educational programs.

Finally, in recognition of the time burden associated with audit committee service, the committee may wish to consider limiting the term of audit committee service, by automatic rotation or by other means.





U.S. Securities and Exchange Commission  
NEWS RELEASE

Washington, D.C. 20549 (202) 942-0029

FOR IMMEDIATE RELEASE

98-96

SEC, NYSE and NASD Announce Blue Ribbon Panel  
To Improve Corporate Audit Committees

John Whitehead and Ira Millstein to Co-Chair Panel

New York, NY, September 28, 1998 – The Securities and Exchange Commission, the New York Stock Exchange and the National Association of Securities Dealers are pleased to announce that the NYSE and the NASD will sponsor a “blue-ribbon” panel drawn from the various constituencies of the financial community to make recommendations on strengthening the role of audit committees in overseeing the corporate financial reporting process. This action was taken in response to recent concerns expressed by SEC Chairman Arthur Levitt about the adequacy of the oversight of the audit process by independent corporate directors.

The panel of eleven members will be co-chaired by John C. Whitehead, former Deputy Secretary of State and retired Co-Chairman and Senior Partner of Goldman, Sachs & Co. and Ira M. Millstein, Senior Partner of Weil Gotshal & Manges LLP and a noted corporate governance expert. It will undertake an intensive study of the effectiveness of audit committees in discharging their oversight responsibilities and, within 90 days, make concrete recommendations for improvement. The panel’s recommendations may include changes to listing standards with respect to the role and composition of audit committees, changes to the auditing standards with respect to how auditors and audit committees interact, new corporate disclosure requirements, and a formulation of “best practices.”

Chairman Arthur Levitt, who delivered a major address on the state of financial reporting on Monday at New York University, praised the actions of the NYSE and the NASD, saying, “The swiftness of their response indicates the type of financial community leadership we need to keep the American capital markets the deepest, most liquid in the world. I am confident that this group will produce tangible recommendations for improving audit committee oversight of the financial reporting process.”

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“This initiative promises to benefit investors and public corporations alike,” said NYSE Chairman and CEO Richard A. Grasso. “The New York Stock Exchange applauds Chairman Levitt and, as an institution that mandates the highest standards of corporate governance, offers our full support to the panel.”

Frank Zarb, Chairman and CEO of the NASD, who also will serve on the panel, said, “The U.S. capital markets are the most successful in the world because of the integrity of each part of the capital formation process. The audit committees of our public companies play a vital role in this process and have served the investing public well over the years. In an increasingly complex and global marketplace, the role of the audit committees in overseeing the financial implications of corporate decisions will only become more critical.”

In response to their selection, John Whitehead and Ira Millstein acknowledged the importance of the task and affirmed their commitment to producing a blueprint for meaningful change.

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U.S. Securities and Exchange Commission  
NEWS RELEASE

Washington, D.C. 20549 (202) 942-0029

FOR IMMEDIATE RELEASE

98-98

SEC, NYSE, and NASD Announce  
Members of Blue Ribbon Committee  
To Improve Corporate Audit Committees

Washington, D.C., October 6, 1998 – The Securities and Exchange Commission, the New York Stock Exchange and the National Association of Securities Dealers today announced the names of the individuals who will serve on the “blue ribbon” panel created to make recommendations on strengthening the role of audit committees in overseeing the corporate financial reporting process. This action was taken in response to recent concerns expressed by SEC Chairman Arthur Levitt about the adequacy of the oversight of the audit process by independent corporate directors.

The panel will be co-chaired by John C. Whitehead, former Deputy Secretary of State and retired Co-Chairman and Senior Partner of Goldman, Sachs & Co. and Ira M. Millstein, Senior Partner of Weil Gotshal & Manges LLP and a noted corporate governance expert. The other panel members will be:

- John H. Biggs, Chairman, President & CEO, TIAA-CREF;
- Frank J. Borelli, Senior Vice President, CFO & Director, Marsh & McLennan Companies;
- Charles A. Bowsher, Former Comptroller General of the U.S.;
- Dennis D. Dammerman, Senior Vice President - Finance & CFO, General Electric Company;
- Richard A. Grasso, Chairman & CEO, New York Stock Exchange;
- Philip A. Laskawy, Chairman & CEO, Ernst & Young LLP;
- James J. Schiro, CEO, PricewaterhouseCoopers;
- William C. Steere, Jr., Chairman & CEO, Pfizer; and
- Frank G. Zarb, Chairman & CEO, National Association of Securities Dealers.

SEC Chairman Arthur Levitt said of the panel, “This top- notch group of corporate and industry leaders is well- positioned to examine the workings of the corporate

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audit committee and to make concrete recommendations for its improvement. I thank each of these members for their time and commitment to this important undertaking.”

“I’m honored to work with this distinguished group on this important issue,” said co-chair Ira M. Millstein. “By collaborating with leaders from the SRO’s, the accounting profession, the corporate and banking sectors, the institutional investment community and former government officials, we hope to forge credible, practical and real guidance on how to improve the effectiveness of corporate audit committees. We are, of course, planning to solicit views on this subject from the interested community.”

The committee will undertake an intensive study of the effectiveness of audit committees in discharging their oversight responsibilities and, within 90 days, make concrete recommendations for improvement. The panel’s recommendations may include changes to listing standards with respect to the role and composition of audit committees, changes to the auditing standards with respect to how auditors and audit committees interact, new corporate disclosure requirements, and a formulation of “best practices.”

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## BLUE RIBBON COMMITTEE ON IMPROVING THE EFFECTIVENESS OF CORPORATE AUDIT COMMITTEES

(New York City, November 4, 1998). The Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees announced a request for public comment on possible recommendations for improving the performance of corporate audit committees in carrying out their responsibilities, including oversight of the financial reporting process.

The Blue Ribbon Committee also announced an all-day hearing at which a selected group of those interested in the corporate financial reporting process will have an opportunity to make presentations on the role of audit committees and to propose suggestions for improving the process.

The Blue Ribbon Committee, co-chaired by John Whitehead, former Deputy Secretary of State and retired Co-Chairman and Senior Partner of Goldman, Sachs & Co., and Ira Millstein, Senior Partner of Weil, Gotshal & Manges LLP, was created by the New York Stock Exchange and the National Association of Securities Dealers in response to concerns about the financial reporting process recently expressed by Chairman Arthur Levitt of the U.S. Securities and Exchange Commission.

### PROCEDURE TO SUBMIT PUBLIC COMMENTS

All comments addressing these and other topics should be sent no later than December 1, 1998 to:

The Blue Ribbon Committee on Improving  
the Effectiveness of Corporate Audit Committees  
c/o Paula Lowitt, Esq.  
Weil, Gotshal & Manges LLP  
767 Fifth Avenue  
New York, N.Y. 10153

### PUBLIC HEARING

At the hearing, The Blue Ribbon Committee will hear presentations by several panels representing different perspectives on the financial reporting process.

Date: December 9th  
Time: 8:00 AM - 2:00 PM  
Place: TIAA-CREF  
730 Third Avenue (between 45th and 46th)  
Clifton R. Wharton Auditorium, 17th Floor  
New York, New York

Admission: Open to the public (seating will be limited).

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#### TOPICS TO BE CONSIDERED

After completing its examination of audit committees, the Blue Ribbon Committee contemplates issuing a series of recommendations to the SEC, the SROs, and the auditor and corporate communities on how to make this oversight process more effective.

The Committee requests that interested parties, although free to submit suggestions pertaining to other areas of concern, consider whether improvements can be obtained through changes pertaining to the following specific areas:

#### POSSIBLE CHANGES TO SRO LISTING STANDARDS

**Requirement of Committee of “Independent” Directors.** Should the definition of “independent director” be broadened by expanding the types of relationships that would disqualify a director from serving on an audit committee? Should each member of an audit committee be required to be independent?

**Imposing a Qualification Requirement for Audit Committee Service.** Should membership on an audit committee be fortified by requiring one or more directors to have a background in finance or accounting? Should there be term limits for audit committee membership or required rotation of the chairman of the audit committee?

**Requiring a Charter Specifying Audit Committee Oversight Responsibilities.** Should an audit committee be required to adopt a charter describing its duties and its relationship with internal and external auditors and management in the context of its oversight of a company’s financial reporting process?

**Requirement for Companies to Adopt Internal Controls.** Should companies be required to adopt a set of internal controls for use in the financial reporting process? Should the audit committee assess and report on the adequacy of these controls?

#### POSSIBLE EXPANSION OF SEC DISCLOSURE REQUIREMENTS

**Requirement for a Report.** Should the SEC disclosure requirements be expanded to require a report prepared by the audit committee discussing, for example, its members’ qualifications, the nature and extent of its activities including any responsibilities for legal and ethical compliance, and the significant accounting issues the committee considers?

**Endorsement of Periodic Reporting Statements.** What responsibilities should the audit committee have for reviewing annual and interim financial information? Should the audit committee be required to be involved in the interim financial statements (e.g. by endorsing or certifying their accuracy)?

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#### FORMULATION OF “BEST PRACTICES” FOR AUDIT COMMITTEES

**Nature of Relationships.** What should be the relationship among the audit committee, the internal and external auditors and management? Specifically, how can the audit committee ensure independence from management?

**Scope of Oversight.** How deeply beyond “process” should the audit committee go in examining reports by internal and external auditors?

**Providing Ability to Hire Outside Advisors.** Will the audit committee be more effective if it has the right to hire independent advisors at its discretion?

**Right of the Audit Committee to Hire the Auditor.** Should the audit committee have an express right to select and manage all relationships with the external auditor, including the provision of audit and non-audit services?

**Formal Practices and Process.** What are the practices that an audit committee should follow in discharging its oversight responsibilities with respect to the financial reporting process (i.e., setting its own agenda and priorities; membership selection by the board, not management)? How should the committee set its priorities - according to risk factors, or otherwise? How should the audit committee deal with accounting irregularities brought to its attention?

**Audit Committee Commitment and Training.** Can audit committees satisfy the important responsibility of overseeing the financial reporting process, given the amount of time typically devoted to such activities? Should companies or auditors provide formal training programs?

#### POSSIBLE REVISIONS TO AUDITING LITERATURE

**Clarification of Client Relationship.** Should the auditing literature be revised to clarify that the primary relationship of an auditor rests with a company’s board of directors and its audit committee?

**Required Disclosure to the Audit Committee.** In communicating with the audit committee, should the external auditors be required to describe the significant financial reporting issues discussed with management and provide a qualitative assessment of a company’s financial reporting — “appropriateness vs. acceptability” (as opposed to limiting those discussions to its compliance with GAAP)?

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## Appendix B

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December 9, 1998 Public Hearing Schedule

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SCHEDULE  
DECEMBER 9, 1998 PUBLIC HEARING SCHEDULE

8:00           Remarks of Co-Chairmen, John C. Whitehead and Ira M. Millstein

SESSION 1

8:20           William T. Allen, Independence Standards Board  
8:40           Donald J. Kirk, Public Oversight Board  
9:00           Olivia Kirtley, American Institute of Certified Public Accountants  
9:20           Sarah Teslik, Council of Institutional Investors  
9:40           Kathleen Gibson, American Society of Corporate Secretaries  
10:00          Break

SESSION 2

10:20          John M. Nash, National Association of Corporate Directors  
10:40          Kenneth S. Janke, National Association of Investors  
11:00          William B. Patterson, AFL-CIO  
11:20          P. Norman Roy, Financial Executives Institute  
11:40          William G. Bishop, Institute of Internal Auditors  
12:00 - 1:00   Lunch

SESSION 3

1:00           Richard M. Swanson, Institute of Management Accountants  
1:20           Joseph Hinsey IV, Harvard Business School  
1:40           Curtis Barnette, Business Roundtable

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## Appendix C

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### Sample Audit Committee Charters

In the interest of encouraging audit committees to consider and discuss the appropriate contents for their audit committee charters, the Committee includes in this Appendix C several sample audit committee charters.

The Committee does not formally endorse the form or contents of these charters and recognizes that they may not contain many of the progressive measures advanced by the recommendations in this Report. Nonetheless, the Committee advances these samples as illustrations of charters that have been developed as models or employed in actual practice.

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## AUDIT COMMITTEE CHARTER<sup>1</sup>

### CONTINUOUS ACTIVITIES - GENERAL

1. Provide an open avenue of communication between the independent auditor, Internal Audit, and the Board of Directors.
2. Meet four times per year or more frequently as circumstances require. The Committee may ask members of management or others to attend meetings and provide pertinent information as necessary.
3. Confirm and assure the independence of the independent auditor and the objectivity of the internal auditor.
4. Review with the independent auditor and the Director of Internal Audit the coordination of audit efforts to assure completeness of coverage, reduction of redundant efforts, and the effective use of audit resources.
5. Inquire of management, the independent auditor, and the Director of Internal Audit about significant risks or exposures and assess the steps management has taken to minimize such risk to the AICPA and Related Entities.
6. Consider and review with the independent auditor and the Director of Internal Audit:
  - (a) The adequacy of AICPA's and Related Entities' internal controls including computerized information system controls and security.
  - (b) Related findings and recommendations of the independent auditor and Internal Audit together with management's responses.
7. Consider and review with management, the Director of Internal Audit and the independent auditor:
  - (a) Significant findings during the year, including the Status of Previous Audit Recommendations.
  - (b) Any difficulties encountered in the course of audit work including any restrictions on the scope of activities or access to required information.
  - (c) Any changes required in the planned scope of the Internal Audit plan.
  - (d) The Internal Audit Department charter, budget and staffing.

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8. Meet periodically with the independent auditor, the Director of Internal Audit and management in separate executive sessions to discuss any matters that the Committee or these groups believe should be discussed privately with the Audit Committee.
  9. Report periodically to the Board of Directors on significant results of the foregoing activities.
  10. Instruct the independent auditor that the Board of Directors, as the members' representative, is the auditor's client.

#### CONTINUOUS ACTIVITIES - RE: REPORTING SPECIFIC POLICIES

1. Advise financial management and the independent auditor they are expected to provide a timely analysis of significant current financial reporting issues and practices.
2. Provide that financial management and the independent auditor discuss with the audit committee their qualitative judgments about the appropriateness, not just the acceptability, of accounting principles and financial disclosure practices used or proposed to be adopted by the Institute and, particularly, about the degree of aggressiveness or conservatism of its accounting principles and underlying estimates.
3. Inquire as to the auditor's independent qualitative judgments about the appropriateness, not just the acceptability, of the accounting principles and the clarity of the financial disclosure practices used or proposed to be adopted by the Institute.
4. Inquire as to the auditor's views about whether management's choices of accounting principles are conservative, moderate, or aggressive from the perspective of income, asset, and liability recognition, and whether those principles are common practices or are minority practices.
5. Determine, as regards to new transactions or events, the auditor's reasoning for the appropriateness of the accounting principles and disclosure practices adopted by management.
6. Assure that the auditor's reasoning is described in determining the appropriateness of changes in accounting principles and disclosure practices.
7. Inquire as to the auditor's views about how the Institute's choices of accounting principles and disclosure practices may affect members and public views and attitudes about the Institute.

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## SCHEDULED ACTIVITIES

1. Recommend the selection of the independent auditor for approval by the Board of Directors and election by Council, approve and compensation of the independent auditor, and review and approve the discharge of the independent auditor.
2. Consider, in consultation with the independent auditor and the Director of Internal Audit, the audit scope and plan of the independent auditor and the internal auditors.
3. Review with management and the independent auditor the results of annual audits and related comments in consultation with the Finance Committee and other committees as deemed appropriate including:
  - (a) The independent auditor's audit of the AICPA's and Related Entities' annual financial statements, accompanying footnotes and its report thereon.
  - (b) Any significant changes required in the independent auditor's audit plans.
  - (c) Any difficulties or disputes with management encountered during the course of the audit.
  - (d) Other matters related to the conduct of the audit which are to be communicated to the Audit Committee under Generally Accepted Auditing Standards.
4. Review the results of the annual audits of member reimbursements, director and officers' expense accounts and management perquisites prepared by Internal Audit and the independent auditor respectively.
5. Review annually with the independent auditor and the Director of Internal Audit the results of the monitoring of compliance with the Institute's code of conduct.
6. Describe in the AICPA's Annual Report the Committee's composition and responsibilities, and how they were discharged.
7. Arrange for the independent auditor to be available to the full Board of Directors at least annually to help provide a basis for the board to recommend to Council the appointment of the auditor.
8. Assure that the auditor's reasoning is described in accepting or questioning significant estimates by management.
9. Review and update the Committee's Charter annually.

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“WHEN NECESSARY” ACTIVITIES

1. Review and concur in the appointment, replacement, reassignment, or dismissal of the Director of Internal Audit.
2. Review and approve requests for any management consulting engagement to be performed by the Institute’s independent auditor and be advised of any other study undertaken at the request of management that is beyond the scope of the audit engagement letter.
3. Review periodically with general counsel legal and regulatory matters that may have a material impact on the AICPA’s and Related Entities’ financial statements, compliance policies and programs.
4. Conduct or authorize investigations into any matters within the Committee’s scope of responsibilities. The Committees shall be empowered to retain independent counsel and other professionals to assist in the conduct of any investigation.

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## SAMPLE AUDIT COMMITTEE CHARTER<sup>1</sup>

### Organization

There shall be a committee of the board of directors to be known as the audit committee. The audit committee shall be composed of directors who are independent of the management of the corporation and are free of any relationship that, in the opinion of the board of directors, would interfere with their exercise of independent judgment as a committee member.

### Statement of Policy

The audit committee shall provide assistance to the corporate directors in fulfilling their responsibility to the shareholders, potential shareholders, and investment community relating to corporate accounting, reporting practices of the corporation, and the quality and integrity of the financial reports of the corporation. In so doing, it is the responsibility of the audit committee to maintain free and open means of communication between the directors, the independent auditors, the internal auditors, and the financial management of the corporation.

### Responsibilities

In carrying out its responsibilities, the audit committee believes its policies and procedures should remain flexible, in order to best react to changing conditions and to ensure to the directors and shareholders that the corporate accounting and reporting practices of the corporation are in accordance with all requirements and are of the highest quality.

In carrying out these responsibilities, the audit committee will:

- Review and recommend to the directors the independent auditors to be selected to audit the financial statements of the corporation and its divisions and subsidiaries.
- Meet with the independent auditors and financial management of the corporation to review the scope of the proposed audit for the current year and the audit procedures to be utilized, and at the conclusion thereof review such audit, including any comments or recommendations of the independent auditors.
- Review with the independent auditors, the company's internal auditor, and financial and accounting personnel, the adequacy and effectiveness of the accounting and financial controls of the corporation, and elicit any recommendations for the improvement of such internal control procedures or particular areas where new or more detailed controls or procedures are desirable. Particular emphasis should be given to the adequacy of such internal controls to expose any payments, transactions, or procedures that

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might be deemed illegal or otherwise improper. Further, the committee periodically should review company policy statements to determine their adherence to the code of conduct.

- Review the internal audit function of the corporation including the independence and authority of its reporting obligations, the proposed audit plans for the coming year, and the coordination of such plans with the independent auditors.
- Receive prior to each meeting, a summary of findings from completed internal audits and a progress report on the proposed internal audit plan, with explanations for any deviations from the original plan.
- Review the financial statements contained in the annual report to shareholders with management and the independent auditors to determine that the independent auditors are satisfied with the disclosure and content of the financial statements to be presented to the shareholders. Any changes in accounting principles should be reviewed.
- Provide sufficient opportunity for the internal and independent auditors to meet with the members of the audit committee without members of management present. Among the items to be discussed in these meetings are the independent auditors' evaluation of the corporation's financial, accounting, and auditing personnel, and the cooperation that the independent auditors received during the course of the audit.
- Review accounting and financial human resources and succession planning within the company.
- Submit the minutes of all meetings of the audit committee to, or discuss the matters discussed at each committee meeting with, the board of directors.
- Investigate any matter brought to its attention within the scope of its duties, with the power to retain outside counsel for this purpose if, in its judgment, that is appropriate.

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## SAMPLE AUDIT COMMITTEE CHARTER<sup>1</sup>

The audit committee is a committee of the board of directors. Its primary function is to assist the board in fulfilling its oversight responsibilities by reviewing the financial information which will be provided to the shareholders and others, the systems of internal controls which management and the board of directors have established, and the audit process.

In meeting its responsibilities, the audit committee is expected to:

1. Provide an open avenue of communication between the internal auditors, the independent accountant, and the board of directors.
2. Review and update the committee's charter annually.
3. Recommend to the board of directors the independent accountants to be nominated, approve the compensation of the independent accountant, and review and approve the discharge of the independent accountants.
4. Review and concur in the appointment, replacement, reassignment, or dismissal of the director of internal auditing.
5. Confirm and assure the independence of the internal auditor and the independent accountant, including a review of management consulting services and related fees provided by the independent accountant.
6. Inquire of management, the director of internal auditing, and the independent accountant about significant risks or exposures and assess the steps management has taken to minimize such risk to the company.
7. Consider, in consultation with the independent accountant and the director of internal auditing, the audit scope and plan of the internal auditors and the independent accountant.
8. Consider with management and the independent accountant the rationale for employing audit firms other than the principal independent accountant.
9. Review with the director of internal auditing and the independent accountant the coordination of audit effort to assure completeness of coverage, reduction of redundant efforts, and the effective use of audit resources.

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10. Consider and review with the independent accountant and the director of internal auditing:
    - (a) The adequacy of the company's internal controls including computerized information system controls and security.
    - (b) Any related significant findings and recommendations of the independent accountant and internal auditing together with management's responses thereto.
  11. Review with management and the independent accountant at the completion of the annual examination:
    - (a) The company's annual financial statements and related footnotes.
    - (b) The independent accountant's audit of the financial statements and his or her report thereon.
    - (c) Any significant changes required in the independent accountant's audit plan.
    - (d) Any serious difficulties or disputes with management encountered during the course of the audit.
    - (e) Other matters related to the conduct of the audit which are to be communicated to the committee under generally accepted auditing standards.
  12. Consider and review with management and the director of internal auditing:
    - (a) Significant findings during the year and management's responses thereto.
    - (b) Any difficulties encountered in the course of their audits, including any restrictions on the scope of their work or access to required information.
    - (c) Any changes required in the planned scope of their audit plan.
    - (d) The internal auditing department budget and staffing.
    - (e) The internal auditing department charter.
    - (f) Internal auditing's compliance with The IIA's Standards for the Professional Practice of Internal Auditing (Standards).
  13. Review filings with the SEC and other published documents containing the company's financial statements and consider whether the information contained in these documents is consistent with the information contained in the financial statements.

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14. Review with management, the independent accountant, and the director of internal auditing the interim financial report before it is filed with the SEC or other regulators.
  15. Review policies and procedures with respect to officers' expense accounts and perquisites, including their use of corporate assets, and consider the results of any review of these areas by the internal auditor or the independent accountant.
  16. Review with the director of internal auditing and the independent accountant the results of their review of the company's monitoring compliance with the company's code of conduct.
  17. Review legal and regulatory matters that may have a material impact on the financial statements, related company compliance policies, and programs and reports received from regulators.
  18. Meet with the director of internal auditing, the independent accountant, and management in separate executive sessions to discuss any matters that the committee or these groups believe should be discussed privately with the audit committee.
  19. Report committee actions to the board of directors with such recommendations as the committee may deem appropriate.
  20. Prepare a letter for inclusion in the annual report that describes the committee's composition and responsibilities, and how they were discharged.
  21. The audit committee shall have the power to conduct or authorize investigations into any matters within the committee's scope of responsibilities. The committee shall be empowered to retain independent counsel, accountants, or others to assist it in the conduct of any investigation.
  22. The committee shall meet at least four times per year or more frequently as circumstances require. The committee may ask members of management or others to attend the meeting and provide pertinent information as necessary.
  23. The committee will perform such other functions as assigned by law, the company's charter or bylaws, or the board of directors.

The membership of the audit committee shall consist of at least five independent members of the board of directors who shall serve at the pleasure of the board of directors. Audit committee members and the committee chairman shall be designated by the full board of directors upon the recommendation of the nominating committee.

The duties and responsibilities of a member of the audit committee are in addition to those duties set out for a member of the board of directors.

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## CHARTER AND POWERS OF THE AUDIT COMMITTEE<sup>1</sup>

RESOLVED, that the charter and powers of the Audit Committee of the Board of Directors (the "Audit Committee") shall be:

- Overseeing that management has maintained the reliability and integrity of the accounting policies and financial reporting and disclosure practices of the Company;
- Overseeing that management has established and maintained processes to assure that an adequate system of internal control is functioning within the Company;
- Overseeing that management has established and maintained processes to assure compliance by the Company with all applicable laws, regulations and Company policy;

RESOLVED, that the Audit Committee shall have the following specific powers and duties:

1. Holding such regular meetings as may be necessary and such special meetings as may be called by the Chairman of the Audit Committee or at the request of the independent accountants or the General Auditor;
2. Creating an agenda for the ensuing year;
3. Reviewing the performance of the independent accountants and making recommendations to the Board of Directors regarding the appointment or termination of the independent accountants;
4. Conferring with the independent accountants and the internal auditors concerning the scope of their examinations of the books and records of the Company and its subsidiaries; reviewing and approving the independent accountants' annual engagement letter; reviewing and approving the Company's internal audit charter, annual audit plans and budgets; directing the special attention of the auditors to specific matters or areas deemed by the Committee or the auditors to be of special significance; and authorizing the auditors to perform such supplemental reviews or audits as the Committee may deem desirable;
5. Reviewing with management, the independent accountants and internal auditors significant risks and exposures, audit activities and significant audit findings;
6. Reviewing the range and cost of audit and non-audit services performed by the independent accountants;

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7. Reviewing the Company's audited annual financial statements and the independent accountants' opinion rendered with respect to such financial statements, including reviewing the nature and extent of any significant changes in accounting principles or the application therein;
  8. Reviewing the adequacy of the Company's systems of internal control;
  9. Obtaining from the independent accountants and internal auditors their recommendations regarding internal controls and other matters relating to the accounting procedures and the books and records of the Company and its subsidiaries and reviewing the correction of controls deemed to be deficient;
  10. Providing an independent, direct communication between the Board of Directors, internal auditors and independent accountants;
  11. Reviewing the adequacy of internal controls and procedures related to executive travel and entertainment, including use of Company-owned aircraft;
  12. Reviewing with appropriate Company personnel the actions taken to ensure compliance with the Company's Code of Conduct and the results of confirmations and violations of such Code;
  13. Reviewing the programs and policies of the Company designed to ensure compliance with applicable laws and regulations and monitoring the results of these compliance efforts;
  14. Reviewing the procedures established by the Company that monitor the compliance by the Company with its loan and indenture covenants and restrictions;
  15. Reporting through its Chairman to the Board of Directors following the meetings of the Audit Committee;
  16. Maintaining minutes or other records of meetings and activities of the Audit Committee;
  17. Reviewing the powers of the Committee annually and reporting and making recommendations to the Board of Directors on these responsibilities;
  18. Conducting or authorizing investigations into any matters within the Audit Committee's scope of responsibilities. The Audit Committee shall be empowered to retain independent counsel, accountants, or others to assist it in the conduct of any investigation;
  19. Considering such other matters in relation to the financial affairs of the Company and its accounts, and in relation to the internal and external audit of the Company as the Audit Committee may, in its discretion, determine to be advisable.

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# AUDIT COMMITTEE OF THE BOARD OF DIRECTORS<sup>1</sup>

## CHARTER

### I. PURPOSE

The primary function of the Audit Committee is to assist the Board of Directors in fulfilling its oversight responsibilities by reviewing: the financial reports and other financial information provided by the Corporation to any governmental body or the public; the Corporation's systems of internal controls regarding finance, accounting, legal compliance and ethics that management and the Board have established; and the Corporation's auditing, accounting and financial reporting processes generally. Consistent with this function, the Audit Committee should encourage continuous improvement of, and should foster adherence to, the corporation's policies, procedures and practices at all levels. The Audit Committee's primary duties and responsibilities are to:

- Serve as an independent and objective party to monitor the Corporation's financial reporting process and internal control system.
- Review and appraise the audit efforts of the Corporation's independent accountants and internal auditing department.
- Provide an open avenue of communication among the independent accountants, financial and senior management, the internal auditing department, and the Board of Directors.

The Audit Committee will primarily fulfill these responsibilities by carrying out the activities enumerated in Section IV. of this Charter.

### II. COMPOSITION

The Audit Committee shall be comprised of three or more directors as determined by the Board, each of whom shall be independent directors, and free from any relationship that, in the opinion of the Board, would interfere with the exercise of his or her independent judgment as a member of the Committee. [Restate here, Board's definition of "independence."] All members of the Committee shall have a working familiarity with basic finance and accounting practices, and at least one member of the Committee shall have accounting or related financial management expertise. Committee members may enhance their familiarity with finance and accounting by participating in educational programs conducted by the Corporation or an outside consultant.

The members of the Committee shall be elected by the Board at the annual organizational meeting of the Board or until their successors shall be duly elected and qualified. Unless a Chair is elected by the full Board, the members of the Committee may designate a Chair by majority vote of the full Committee membership.

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### III. MEETINGS

The Committee shall meet at least four times annually, or more frequently as circumstances dictate. As part of its job to foster open communication, the Committee should meet at least annually with management, the director of the internal auditing department and the independent accountants in separate executive sessions to discuss any matters that the Committee or each of these groups believe should be discussed privately. In addition, the Committee or at least its Chair should meet with the independent accountants and management quarterly to review the Corporation's financials consistent with IV.4. below).

### IV. RESPONSIBILITIES AND DUTIES

To fulfill its responsibilities and duties the Audit Committee shall:

#### Documents/Reports Review

1. Review and update this Charter periodically, at least annually, as conditions dictate.
2. Review the organization's annual financial statements and any reports or other financial information submitted to any governmental body, or the public, including any certification, report, opinion, or review rendered by the independent accountants.
3. Review the regular internal reports to management prepared by the internal auditing department and management's response.
4. Review with financial management and the independent accountants the 10-Q prior to its filing or prior to the release of earnings. The Chair of the Committee may represent the entire Committee for purposes of this review.

#### Independent Accountants

5. Recommend to the Board of Directors the selection of the independent accountants, considering independence and effectiveness and approve the fees and other compensation to be paid to the independent accountants. On an annual basis, the Committee should review and discuss with the accountants all significant relationships the accountants have with the Corporation to determine the accountants' independence.
6. Review the performance of the independent accountants and approve any proposed discharge of the independent accountants when circumstances warrant.
7. Periodically consult with the independent accountants out of the presence of management about internal controls and the fullness and accuracy of the organization's financial statements.

#### Financial Reporting Processes

8. In consultation with the independent accountants and the internal auditors, review the integrity of the organization's financial reporting processes, both internal and external.
9. Consider the independent accountants' judgments about the quality and appropriateness of the Corporation's accounting principles as applied in its financial reporting.

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10. Consider and approve, if appropriate, major changes to the Corporation's auditing and accounting principles and practices as suggested by the independent accountants, management, or the internal auditing department.

#### Process Improvement

11. Establish regular and separate systems of reporting to the Audit Committee by each of management, the independent accountants and the internal auditors regarding any significant judgments made in management's preparation of the financial statements and the view of each as to appropriateness of such judgments.
12. Following completion of the annual audit, review separately with each of management, the independent accountants and the internal auditing department any significant difficulties encountered during the course of the audit, including any restrictions on the scope of work or access to required information.
13. Review any significant disagreement among management and the independent accountants or the internal auditing department in connection with the preparation of the financial statements.
14. Review with the independent accountants, the internal auditing department and management the extent to which changes or improvements in financial or accounting practices, as approved by the Audit Committee, have been implemented. (This review should be conducted at an appropriate of time subsequent to implementation of changes or improvements, as decided by the Committee.)

#### Ethical and Legal Compliance

15. Establish, review and update periodically a Code of Ethical Conduct and ensure that management has established a system to enforce this Code.
16. Review management's monitoring of the Corporation's compliance with the organization's Ethical Code, and ensure that management has the proper review system in place to ensure that Corporation's financial statements, reports and other financial information disseminated to governmental organizations, and the public satisfy legal requirements.
17. Review activities, organizational structure, and qualifications of the internal audit department.
18. Review, with the organization's counsel, legal compliance matters including corporate securities trading policies.
19. Review, with the organization's counsel, any legal matter that could have a significant impact on the organization's financial statements.
20. Perform any other activities consistent with this Charter, the Corporation's By-laws and governing law, as the Committee or the Board deems necessary or appropriate.

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