March 10, 1999

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

Some Questions and Suggestions

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Questions:

1. Do the recommendations as a whole confuse the roles of the board, the audit committee, the management and the auditors. Is this a further weakening of the responsibility of the auditors for the "quality of the financial statements."

2. Is the definition of independence in Recommendation 1 too restrictive. Why should a board determination with respect to independence be the subject of special proxy statement disclosure. Is this a way of deterring a board determination of independence by requiring a form of disclosure with negative connotations. Is not the present NYSE definition of independence all that is needed or appropriate.

3. Is it necessary to specify that audit committee members be financially literate. Doesn't this discourage directors from agreeing to serve. Will this create a form of two-tier board with the financially literate being deferred to in connection with financial and accounting matters. Does specifying financial literacy create a litigation problem — if you are financially literate does it detract from your ability to argue you relied on the management and the auditors. Even if state law is not undermined, how does this play in a jury trial.

4. Why should the audit committee and the full board adopt a charter. Again, it would appear to create a liability problem if the charter were not slavishly followed. Does this amount to another form of box-checking.

5. Is Recommendation 5 to the SEC to promulgate a rule for proxy statement disclosure of the audit committee charter and compliance with the charter another manifestation of distrust of directors. While the safe harbor may protect against federal securities law liabilities, it will not protect against state law liabilities.

6. Recommendation 6 seems to merely state what the law and practice are. Is anything further necessary.

7. Is the Recommendation 8 requirement as to the "quality" of the accounting standards practical. Should this be the responsibility of the audit committee. Does this let the auditors off the hook. Will this result in a requirement of disclosure that the financial statements do not reflect the highest possible degree of conservatism and a reconciliation to that state.

8. Is Recommendation 9 another useless disclosure that creates liability problems despite a safe harbor.

9. Is Recommendation 10 needed in light of the current practice of the auditors.

Suggestions:

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~~ three 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 (other than dividends or interest) 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 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).

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 financial literate within a reasonable period of time after his or her appointment to~~ provided with appropriate information as to the purposes and processes of 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).

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~~ written description of 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~~ and review such description 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.~~ Omit **Recommendation 5** and rely on present SEC requirement for a description of the corporations committees in the proxy statement.

Recommendation 6

The Committee recommends that the listing rules for both the NYSE and the NASD require that the resolution or bylaw creating the audit committee ~~charter for~~ of 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 resolution or bylaw creating the audit committee ~~charter for~~ of 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.

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~~[__________________________________] the 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) 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.~~ Omit **Recommendation 9** on the basis that is does not add anything other than more boilerplate.

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.

------------------ COMPARISON OF FOOTNOTES ------------------

~~-FOOTNOTE 1-~~
~~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.~~

------------------ COMPARISON OF HEADERS ------------------

-HEADER 1-
Wachtell, Lipton, Rosen & Katz

-HEADER 2-
Wachtell, Lipton, Rosen & Katz