



**Guide to
Forming and
Running an
Effective Audit
Committee**





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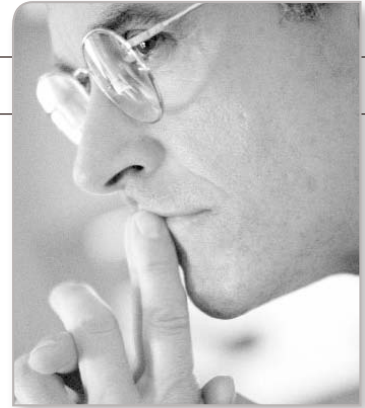




Introduction

“The independent audit committee fulfills a vital role in corporate governance. The audit committee can be a critical component ensuring quality reporting and controls, as well as the proper identification and management of risk... Its critical role as guardian of the company’s integrity puts the audit committee at the core of the challenge of governance.”

Report of the National Association of Corporate Directors Blue Ribbon Commission on Audit Committees (NACD Report)



Report of the National Association of Corporate Directors Blue Ribbon Commission on Audit Committees (NACD Report)

This view is shared by Congressional representatives, the stock exchanges and the SEC.

Since the 1970s, the nature and prevalence of audit committees have been in a constant state of evolution, with each new wave breaking with increasing intensity.

The financial world of the 1970s was rocked by slush funds and foreign bribes that forced a large number of companies to form audit committees. In the 1980s, the National Commission on Fraudulent Financial Reporting (Treadway Commission) was set up in response to a rash of well-publicized

cases of fraudulent financial reporting.

In the early 1990s, the Public Oversight Board (POB) issued reports, including recommendations for greater audit committee responsibilities and more timely, frequent and open contacts with the external auditors.

In the late 1990s, in response to SEC urging, the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD) produced the Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees. As a result of the Committee’s findings, the major exchanges adopted rules expanding audit committee requirements, and the SEC set new disclosure rules. The onset of the millennium also produced a special study by the Committee

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of Sponsoring Organizations of the Treadway Commission (COSO), which found that most cases of financial fraud involved small Nasdaq or over-the-counter companies with weak audit committees.

Effective audit committees are not merely creatures of government and industry-sponsored initiatives, however. Boards of directors have other persuasive reasons to perform effectively their oversight role in ensuring reliable financial reporting and maintaining investor confidence (e.g., avoiding class action law-suits and criminal prosecution, and preventing the delisting of the company's stock that may result from financial fraud).

While it is clear that an informed and vigilant audit committee is an essential element of an efficient securities market, an audit committee's duties and responsibilities are diverse and may need elaboration.

This Guide to Forming and Running an Effective Audit Committee incorporates the specific recommendations, guidelines and rules of the SEC, the Blue Ribbon Committee, the stock exchanges, the Independence Standards Board (ISB), the SEC Practice Section (SECPS) and the Auditing Standards Board of the American Institute of Certified Public Accountants (AICPA). Its purpose is

to provide you with an over-view of the common functions and responsibilities of an audit committee to help you and your company: (1) form and maintain an effective audit committee; and(2) set an appropriate agenda for its ongoing activities. However, your company's specific circumstances, as well as the distinctive nature of the relationships among the audit committee, company management, internal auditors and outside professionals, should dictate the role of your audit committee.

Your Crosslin & Associates advisor is ready to assist you in structuring your audit committee, or in evaluating the suitability of your present audit committee practices, in light of your company's particular needs and objectives.



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Eight Essential Attributes for an Effective Audit Committee

To create an effective audit committee, it is best to attract members who have a special blend of qualifications and abilities. We believe eight attributes are needed for an audit committee to function most effectively.

“If the audit committee is to accomplish nothing else, it should first and foremost strive to establish the right tone at the top. If the appropriate tone at the top is established and communicated, every division, department and individual within the organization will be pulling in the same direction. Without the appropriate tone at the top you haven’t got a chance.”

Michael Young, Accounting Irregularities and Financial Fraud, Harcourt Professional Publications

1 Create the Right Tone at the Top

The committee should ensure that the ethical and compliance commitments of management and employees are understood throughout the company. The message to all personnel should be loud and clear: financial misreporting is totally unacceptable. If any misreporting is noted, it must be dealt with quickly and appropriately.

William Jones, the philosopher, once divided people into two types: the tough-minded and the tender-minded. When it comes to an audit committee, particularly its chair, the tough-minded approach is the only option. This view was echoed by SEC Chairman Arthur Levitt, who said, “...tough-minded audit committees represent the most reliable guardians of the public interest.” An audit committee

must be able to ask probing and often difficult questions about the company’s affairs, and not flinch when controversial matters arise. This can only operate when the audit committee assumes an active role. Audit committees need to be a visible part of the financial fraud prevention process, rather than rely excessively on management and the auditors. While management and the auditors have particular in-depth expertise and knowledge of the company’s business, audit committee members must avoid being intimidated by these attributes. Although the committee should be tough-minded, members should also know the difference between appropriate inquiry and unwarranted interference in the prerogatives of management. The company should expect its audit committee to insist on receiving bad news promptly and fully. The committee should be





among the first to be informed of any problems or concerns and the first to question when something appears out of line. The committee should also be alert to any employee who appears to be under too much pressure and is afraid to report bad news, or any danger where results may be camouflaged. The entire company must work toward a common goal of reporting financial transactions properly.

Tone at the top should not be a sterile mission statement relegated to the company's archives. Rather, it is a pervasive attitude created through management and audit committee actions that are clearly visible throughout the company.

Communicating tone at the top to company employees can be achieved through different means. One way is through a written Code of Conduct addressing such matters as company policy on bribes, political contributions, conflicts of interest and unauthorized payments, and reporting of such violations without fear of reprisal. However, care must be taken to avoid having the Code become mere boilerplate or, worse, at variance with the actual corporate culture. A more effective way of spreading the word through all

levels of the corporate ranks is through an active reinforcement by management who is committed to leading by example. The audit committee should encourage the flow of information from all employees to itself and should encourage reporting of bad news. It can also insist that all personnel cooperate with the internal and external auditors by being truthful and forthright and by not permitting any attempts to conceal inappropriate behavior.

The audit committee should challenge the propriety of the company's financial reporting system and the effectiveness of its internal controls, and monitor improvements. Although it is not easy to stand firm and insist on changes when management believes otherwise, that is the audit committee's role.

Audit committees should also be alert to any indications that there may be improper earnings management. Meeting the quarterly and annual earnings

expectations of financial analysts can place enormous pressure on management to "push the envelope" of acceptable accounting practices, or go beyond it by fraudulently manipulating the numbers. Additional motivations to misstate the numbers can come from lucrative earnings-based executive compensation packages. Fertile ground for financial fraud includes revenue recognition, asset impairment, estimated liabilities (particularly in connection with restructurings) and cost deferral. The audit committee should be sensitive to the pressure on management to achieve earnings targets and the areas in the financial reporting system that are most susceptible to fraud. You should seek input from your Crosslin & Associates advisor in this area.

Earnings management is also an area of particular interest to the SEC. In 1998, Chairman Levitt voiced strong concerns about what he perceived to be rampant earnings management practices of some companies, which could,

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in his view, seriously erode the credibility of the financial markets.

Similarly, audit committees should carefully review circumstances when management seeks a second opinion on accounting issues. Many second opinions sought by management are legitimate attempts to obtain technically correct answers to complex problems. Yet, there are some cases where a second opinion is used to pressure the current auditors to agree with a financial statement presentation that coincides with management's interests, even though it may be an unacceptable practice. There is also a risk that the second opinion is based on an incomplete set of facts, which are more fully known by the incumbent auditor.

Discretion is needed when the audit committee handles sensitive or controversial matters that could damage either personal or company reputations. Then, the audit committee must proceed with considerable caution and full respect for the rights of all involved. The advice of outside counsel will probably be needed if such matters arise. Common sense, good legal advice and a clear understanding of the parameters of the committee's role are essential in these circumstances. The audit committee's efforts will

be bolstered if its members truly have in mind the best long-term interests of the company and its shareholders. Individuals who cannot share this vision are probably not the best candidates for committee membership.

While a strong audit committee is important for all companies, it is particularly critical for growing companies, which may often have fewer effective internal controls.

2 Be Independent

A logical extension of the toughness attribute is the need for audit committee members to be truly objective in guarding against fraudulent financial reporting. It is not always easy to resist strong management, or to tell them what they don't want to hear. It is particularly difficult to do this without an independent state of mind. Accordingly, the major stock exchanges (NYSE, Nasdaq and AMEX) require all members of the audit committee to be independent of management, except in unusual circumstances. This independence should encompass audit committee independence in fact as well as in appearance. The audit committee, to be truly effective, must be able to resist management's attempts at com-

promising financial reporting. The major stock exchanges have set rules identifying situations that would impair independence. For example, the following business relationships under all three exchanges would impair independence:

- A director who is or has been an employee of the company during the past three years.
- A director who is employed as an executive of another corporation where any of the company's executives serve on that corporation's compensation committee.
- A director who is an immediate family member of someone who has been an executive officer of the company or its affiliates during the past three years.

Each of the major exchanges has additional guidelines regarding business relationships that would impair a member's independence. For instance, the NYSE considers a director who has a direct business relationship with the company (e.g., a consultant) not to be independent if this relationship occurred within the past three years, unless the board of directors determines otherwise. The Nasdaq and the American Stock Exchange consider a director who accepts compensation in excess



of \$60,000 from the company or any of its affiliates during the previous year (except for board service, benefits under a tax-qualified retirement plan or non-discretionary compensation) not to be independent. For a complete listing of the exchanges' rules, you may wish to visit their specific Web sites. (For the New York Stock Exchange, WWW.NYSE.COM; for Nasdaq and the American Stock Exchange, WWW.NASDAQNEWS.COM).

management should not be able to use the audit fee as a means to influence the auditors, and the audit committee will be in an ideal position to evaluate the quality of the auditors' performance. Moreover, the internal auditors should be given direct access to the audit committee, preserving his or her independence and resisting undue influence by management.

To help preserve its independence, the audit committee should be positioned between top management and the external auditors – and remain independent of both. With this structure,

The Audit Committee's Relationships





3

Reflect a Balance of Skills

Under the stock exchange rules, the audit committee must consist of at least three members who are each “financially literate.” For businesses under a specific threshold, the NASD and AMEX provide some relief from this requirement.

The requirement to have at least three members stems from the need to have a range of views and expertise as well as to be able to manage the workload required of audit committee members. To obtain a balanced perspective, we recommend three to six members with diverse backgrounds. There are various places to look for qualified audit committee members. Some referral sources are executive search firms and professional organizations, such as the National Association of Corporate Directors. In addition, Crosslin & Associates can assist you in locating qualified audit committee members.

To provide for a balanced committee, at least one member should have specific accounting or related financial management expertise. This experience can be met by enlisting an individual that has past experience in finance and accounting, the requisite professional

certificate in accounting or other comparable experience or background which would result in the individual being financially sophisticated. The company should consider individuals that have experience in being or having been a chief executive officer, a chief financial officer, a senior officer of an organization with financial oversight responsibilities or a partner in a public accounting firm with experience in handling publicly held clients.

The remaining members’ knowledge should be consistent with the applicable stock exchanges’ definition of “financially literate.”

This generally means that the committee member must be able to read and understand fundamental financial statements sufficiently to recognize when the numbers don’t make business sense. This ability, coupled with diligence and an inquisitive attitude, will enable members to ask insightful questions and thoughtfully assess the responses.

To help perform their duties, the audit committee members should clearly understand their responsibilities and objectives and receive company-specific training. In that regard, they should understand the company’s

industry, its operations, its system of internal control, and the business risks and risk management processes in place. Armed with this knowledge, they should be able to be sensitive to areas of the financial reporting process that are most exposed to breakdowns – intentional or otherwise. It would also be helpful if all audit committee members received training on new accounting, auditing and regulatory pronouncements, industry trends, any new technology that might affect the company, and any emerging business developments. Your Crosslin & Associate advisor can assist you in obtaining this type of training. The committee members should also understand the company’s beliefs, philosophy, strategic plans, etc., and use this understanding in addressing issues throughout the year. The most effective means of this type of training ordinarily would be through direct discussions with company personnel.

Effective audit committees are chaired by strong individuals. A strong chair should be at the forefront of committee actions; lead the discussions with management and the internal and external auditors; identify issues in advance; and have a probing, analytical mind with the forcefulness to apply it.



4 Make a Time Commitment

Being an audit committee member is not a full-time job. However, committee members must be informed, diligent and probing. This requires a significant time commitment, usually more than typical board service.

How much time should an audit committee member expect to spend on committee work? It depends on the complexity of the company's activities, its stage of evolution, and the magnitude of its issues. However, on average it could be around eight to twelve days per year. The audit committee should meet to discuss scheduled matters, such as quarterly financial information and the year-end audit. If the committee determines that special matters need to be considered, it should meet more frequently. Most audit committees try to schedule their meetings to coincide with regular meetings of the board, which will result in a more effective use of time.

Of paramount concern is the need of the audit committee to set aside enough time to meet so that important matters are given a thorough airing. Meetings that are squeezed into other agendas are usually ineffective and send the wrong message as to the tone at the top.

5 Develop a Clear Charter

To operate properly, a formal written charter strongly backed by the full board should be adopted and annually reassessed. The major exchanges require the charter to include the following:

- The scope of the committee's responsibilities and how it carries them out.
- A statement that the external auditors are ultimately accountable to the board of directors and the audit committee.
- A statement that the board of directors and the audit committee have the authority and responsibility to select,

evaluate and, where appropriate, replace the external auditors.

- A statement that the audit committee is responsible for ensuring that the external auditors submit a formal written statement regarding relationships and services that may impair independence, and for the purpose of discussing any related, relevant matters with the auditors.

In addition to what is required in the charter by the major stock exchanges, the following areas should be considered for inclusion and tailored to suit the needs of each company:

- Requiring the committee to satisfy the board that to the best of its knowledge:
 - The independent audit of the company appears to meet the standards of the accounting profession.
 - The annual and interim financial reports of the company fairly present its financial position and operating results.
 - Internal controls are reliable, and provide adequate safeguards of the company's assets and proper recording of its transactions.

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- Reporting to the board such matters as conflicts of interest; insider stock transactions; the use of company funds for payment of illegal political contributions, bribes, or other unauthorized or illegal payments; and any other questionable business practices that come to its attention.
- Authorizing an investigation of alleged improprieties, including retention of outside counsel or other professional consultants, as needed, in the discharge of its duties.
- Informing the board of significant developments in accounting principles affecting the company, as well as relevant rulings by the SEC and other regulatory bodies.
- Reporting to the board the committee's compensation, expenses, staff support, liability indemnification and other matters pertinent to the committee's interests.
- Informing the board of the terms of appointment, which should be staggered to maintain continuity. Appointees should look to infuse the committee with fresh viewpoints.

The primary purpose of the charter is to create a practical roadmap to help the audit committee achieve its goals. Thus, drafting a seemingly endless list of responsibilities may actually be counterproductive.

After the charter has been drafted and reviewed by counsel, it should be approved by the board and either incorporated into the bylaws or formalized by a board resolution. In addition, the SEC requires companies to disclose in their proxy statements whether the audit committee has a written charter. A copy of the charter is to be included as an appendix to the proxy or information statement at least once every three years.

The sample Audit Committee Charter provided at the end of this booklet is for illustrative purposes only. As such, it may be a useful starting point for a company to use in developing its own charter.

6 Develop Specific Committee Duties

Once a charter has been developed, the audit committee needs to decide which specific regular assignments it will undertake and then have them approved by the board. These tasks should be communicated in writing to company management and the external and internal auditors to ensure a complete understanding of the committee's role. Since clearly defined duties are a key to an effective audit committee, a separate chapter in this booklet is devoted to this subject. While the range of the committee's duties can vary considerably, some responsibilities apply regardless of the company's size (e.g., communications from the external auditors with respect to its audit of the annual financial statements and review of the interim financial statements). In setting the scope of their duties, audit committees should tailor them to the company's circumstances and avoid being overloaded with responsibilities that could cause them to lose focus on their key objectives.



7 Plan the Year's Agenda

The complexity of the company's activities, together with the nature of the duties assumed by the audit committee, will determine its agenda. At least five meetings a year should be considered, although this would depend on the company's particular circumstances. The audit committee should discuss with the external auditors any findings noted as a result of the pre-filing review of unaudited quarterly financial statements and their audit of the financial statements included in the annual report on Form 10-K. Additional meetings may be necessary if special matters arise.

Further thoughts about those meetings and suggestions for their agendas are outlined in the section on Model Meeting Agendas. However, audit committees are cautioned against falling into a checklist mentality where the basic goal is completion of the checklist itself, rather than conducting their own company-specific investigation. Accordingly, these questions should be tailored to the circumstances of each company.

8 Document the Committee's Work

The SEC requires certain matters to be documented by the audit committee. While documentation of other items is good practice, it is not required. The proxy rules require companies to provide an audit committee report in the annual proxy statement. The report is required to indicate:

1. The audit committee has reviewed and discussed the financial statements with management.
2. The audit committee has discussed with the external auditors certain findings from their audit of the financial statements required by professional auditing rules.
3. The audit committee has received a written report from the external auditors regarding their independence, as required by professional standards, and discussed certain issues that

Assuming a calendar-year company, five or six regular audit committee meetings or communications could be timed as follows:

- The Quarterly Review Meetings:** May, August and November
- The Audit Planning Meeting:**September, October or November
(This meeting can sometimes be combined with the third quarterly review meeting.)
- The Pre-Release Meeting:**February or March
(Prior to press release of the annual earnings.)
- The Post-Release Meeting**..... March or April



may be thought to bear on their independence with them.

4. Based on the discussion of items 1-3, the audit committee should make known whether it recommended to the board that the audited financial statements be included in the Annual Report filed with the SEC.

Additionally, for its own protection, as well as to keep the board informed, the audit committee should keep minutes and issue reports that document its conclusions and recommendations. However, the extent to which audit committee meetings are documented in writing should be tempered with the understanding that written documentation can have a chilling effect on candor. Accordingly, based on advice from counsel, consideration should be given to procedures detailing how highly sensitive discussions can be freely explored, but yet still be reported to the board with some assurance

of confidentiality. In that regard, many audit committees prefer holding executive sessions without stenographers or other outside persons present. It may be advisable to discuss sensitive issues (e.g., questionable payments) covered at these sessions with counsel before they are documented in the audit committee's record.

Once the audit committee is formed and its eight essential attributes defined, the committee's attention will be focused more closely on its fundamental responsibilities. These are covered in the next chapter.

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Audit Committee Duties

One of the audit committee’s most challenging assignments is choosing specific duties to perform. Guidance on the extent of the audit committee’s role has come from a number of sources, including the Treadway Commission, the SEC, the various exchanges, the Independence Standards Board and the Blue Ribbon Committee.



From this guidance and from our practical experience, we believe the audit committee’s role falls into three categories, some of which may overlap:

- Financial Reporting
- Risks and Controls
- Audit Function

Financial Reporting

In order to achieve its goal of combating financial fraud, the audit committee must have an unwavering mandate for financial statements that meaningfully portray the company’s circumstances. Some steps to follow in doing this are:

- Review the annual stockholders’ report and Form 10-K before they are released externally. The committee members should clearly understand the following:

- The significant accounting judgments made and estimates included in the financial statements
- The accounting treatment of significant or unusual transactions
- The impact of changes in accounting rules
- The disclosures required
- Evaluate the appropriateness of management seeking a second opinion on significant accounting or auditing issues.
- Be alert to “red flags” which may signal improper earnings management or, worse, fraudulent financial reporting, misappropriation of funds or illegal acts. In that regard, question management and the auditors about such matters as unusual fluctuations in revenue and expenses, inexplicable reserves, changes



in accounting principles or business terms, significant new sources of revenue, and widening disparities between cash and accrual earnings.

- Review audit adjustments made and those waived because of immateriality. The SEC is concerned when companies use narrow concepts of materiality to avoid making adjustments to the financial statements. They are particularly concerned when adjustments are made (or not made) to help a company meet or exceed analysts' consensus earnings estimates. The SEC has made it clear that using purely quantitative materiality criteria (e.g., 5 to 10% of net income) is not enough. Quantitative criteria may be a good first step; however, registrants should also consider qualitative factors, such as adjustments made or not made to satisfy analysts' estimates, turning a loss into a profit, the effect on earnings trends, and the effect on the results of individual reported segments.
- Review the quarterly SEC filings. The committee members should communicate with the external auditors prior to the filings or as soon as practical thereafter to

determine if any matters were identified about which the committee should be aware (e.g., a sensitive accounting estimate or a change in a significant accounting policy affecting the interim financial information).

- Ensure that the financial reports clearly reflect true company performance. In doing so, the committee should be familiar with critical performance indicators such as industry trends and ratios.

Risks and Controls

The seeds of financial fraud are sown in the combination of business and financial risks facing a company and the inability of existing internal controls to cope with them. If the audit committee expects to monitor risks effectively, it must first understand them. Then, by recognizing that a strong internal control system is the key to risk management, it can create the right tone at the top to foster the growth of suitable controls. Some of the risks the audit committee should consider are listed as follows.

- Obtain risk assessments from management and the auditors. Risk comes in many forms, including

economic, legal, financial, environmental, market, technological and competitive. The audit committee cannot be expected to be responsible for monitoring them all, but rather should rely on the special skills and research of other parties to provide input. The committee should ask management and the internal and external auditors about their assessments of business and financial risks in areas relating to the committee's responsibility. This evaluation should cover each key business segment and the general functions that have financial control implications. The committee should perform these inquiries on a regular basis and receive updates whenever there is a major change in risks.

- Receive internal auditors' reports directly from them, with no management filtering. Direct and confidential interaction with the internal auditors can give the committee a sense of the effectiveness of the company's internal control and its compliance with laws, regulations and company policies.



- Review internal and external auditors' recommendations for improving controls and management's responses. In doing so, the committee should focus on more significant control weaknesses. Understanding management's actions and attitudes towards improving control procedures enables the committee to understand management's tone at the top.
- Ensure that the company's infrastructure can support its current and future financial reporting needs. The management information systems must be able to provide management with all the information it needs to run the business while producing clear, accurate and timely external financial reports. For companies that grow through acquisition, management also needs to be mindful of the need for the acquired companies' systems to be compatible with those of the company.
- Obtain written representations from management on the strength of the company's internal controls and information systems.

Audit Function

External Auditors

The audit committee's oversight responsibility for the audit function covers work performed by both external and internal auditors. To oversee these areas, the committee should:

- Interview and evaluate the external auditors from the following perspectives:

Audit approach – how the firm plans the audit, the timeliness of its services, the efficiency of its performance and how effectively it coordinates the work of other offices, both domestic and international. Also, how it polices its own performance, internal review approach and consulting procedures.

Accessibility and location - the ability of the firm to respond to issues in a timely manner, including the relative proximity of the auditors to the company's operating facilities

and corporate headquarters. This can facilitate cooperation, understanding and face-to-face contact.

Personnel – the professional caliber and industry experience of the partners and staff members assigned to the engagement, and the degree to which the partners are involved in the audit. The firm's specialized industry competence and its ability to provide additional services as needed.

The management letter – content of the firm's letter of recommendations to management, including insights into the company's business and internal accounting control needs, and the completeness of its approach.

Working with the committee - the degree of initiative, cooperation and effectiveness of the firm's work with the audit committee.

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Major litigation – whether there are any significant pending lawsuits against the firm and how the firm is dealing with them.

- Obtain agreement from the auditors that the board, rather than management, is the auditors' primary client. To that end, the committee needs to make sure the auditors understand their need for a diligent, unbiased audit and an honest appraisal of management. This environment can help provide free-flowing, candid discussions between the committee and the auditors.
- Confirm and discuss the auditors' independence. As required by professional auditing standards, the committee should obtain from the auditors a written confirmation of its independence under the Securities Acts. In addition, it should discuss with the auditors any relationships between the auditors and the company that may reasonably be thought to bear on independence. The committee should review all non-audit services to be performed by the auditors to evaluate the possible effect on their independence, together with any safeguards

developed by the auditors to mitigate threats to actual loss of objectivity (e.g., special internal reviews). As part of this review, the committee should consider any benefits accruing from the auditors' special knowledge of the company and the enhanced quality of the audit resulting from a more thorough understanding of the company's operations.

- Review the audit fee to ensure that it is in line with the scope of the audit. Based on the review of the auditors' scope and auditing techniques, subsequent discussions with management about problems encountered and the auditors' efficiency in handling the audit, the audit committee should be in a good position to evaluate whether the engagement time and resulting fees are reasonable. While it may be natural to review the fee solely from the perspective of being too high, a fee that is too low may actually provide more risk to the company. An "overly aggressive" negotiated fee can put significant pressure on the auditors when determining an appropriate audit scope that adequately addresses the higher risk areas.
- Discuss the following matters which the auditors are required

to communicate with the audit committee:

- The auditors' responsibility under generally accepted auditing standards. This basically covers the nature and limitations of an audit.
- The quality, not just the acceptability, of the accounting principles followed by the company. Accounting rules are not always precise. Quite often there is great latitude in the judgments that produce financial statements. In that regard, this discussion should include matters such as choices among available alternative accounting principles, evolving reporting issues, the clarity and completeness of how related party dealings and unusual transactions are reported, the nature of reserve accounts, and materiality judgments. In order to foster open and frank discussions of the quality of a company's accounting principles, this is the only part of the mandated discussion that need not be in writing.
- Disagreements with management. These include accounting or auditing matters, whether or not resolved to the auditors' satisfaction. This is a particularly important area because it can shed light on the aggressiveness of



- executives in attempting to manage earnings or the true financial picture of the company.
- Difficulties in performing the audit. This area could include such problems as delays in providing information to the auditors and lack of cooperation.
 - Major issues management discussed with the auditors before their retention. This requirement is aimed at detecting whether management might be prone to opinion shopping.
 - The auditors' limited responsibility for other information in documents containing audited financial statements (e.g., MD&A, selected financial data, president's letter).

Internal Auditors

- Review and approve an internal audit department charter. This charter should describe the mission, accountabilities, independence, responsibilities, authority and standards for the department.
- Review hiring decisions.
- Evaluate the adequacy of the internal audit department personnel, the department budget, and the scope and results of its activities, as well as when appropriate changes in audit coverage should be made.
- Review any plans to outsource the internal audit function. Challenge the pros and cons of such a proposal. In addition, the committee should review

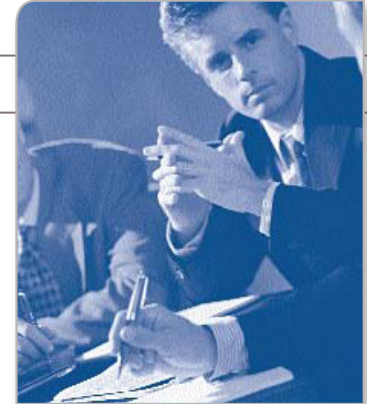
the degree of coordination between the activities of the external and internal auditors. The committee should feel confident that the combined audit scope can be relied on to identify weaknesses in internal controls that could expose the company to fraud or material financial reporting errors. Moreover, the committee should encourage open and direct communications with the auditors. Internal auditors, as well as external auditors, must feel free to report control weaknesses (particularly those resisted by management) to the audit committee on a confidential basis without fear of reprisal.

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Model Meeting Agendas

The prior section covered some of the fundamental responsibilities we believe are essential for an audit committee to exercise its oversight role most effectively. To carry out these responsibilities, a well-defined working plan of the committee's activities is needed. Although this booklet discusses a broad number of responsibilities, the audit committees should, of course, tailor their roles to the special needs of their companies.



This section suggests the timing of certain meetings, the meetings' objectives, any specific actions to be performed, and what the committee should report to the board as a result of the meeting. The section was prepared assuming a five-meeting schedule, and is not intended to be all-inclusive. Rather, these meetings should reflect the company's specific circumstances and the audit committee's particular concerns.

Each meeting typically begins with a discussion of matters of mutual interest among the audit committee, management, the external auditors and the internal auditors, if any. The audit committee can then meet privately with each to discuss candidly sensitive or confidential matters. It may also be

appropriate for company counsel and outside counsel to attend certain meetings.

Material to be discussed at meetings should be clearly prepared and sent to the committee members in sufficient time for them to digest it, so the actual meeting time can be used most productively.

While the audit committee's activities should be carefully planned, its operating structure should not be immutable. Even if the company's business has not changed recently, the audit committee should re-examine its duties and performance level over the last year. This regular self-assessment should be built into the meeting calendar.



Quarterly Review Meetings

Timing

Before the release of earnings or as soon thereafter as practical. (Because of tight time constraints, these meetings can be conducted over the phone.)

Meeting Objectives

To discuss with the external auditors the impact of significant matters noted in the review of the interim financial information.

Action

Discuss any of the following matters as they relate to the interim financial statements:

- Any significant new changes in accounting policies, including their quality (not just their acceptability)
- Management judgments and accounting estimates
- Significant adjustments made or proposed
- Other information contained

in documents containing the financial statements

- Disagreements with management
- Consultation with other auditors
- Difficulties encountered in performing the review

Report to Board

Communicate any items identified by the external auditors.

Audit Planning Meeting

Timing

Several weeks before the start of the audit.

Meeting Objectives

To review the external auditors' audit plan and anticipated non-audit services, and the activities of the internal auditors during the past year.

Risks and Internal Controls

- Business and financial risks identified by management and the auditors
- Management overview
- Industry conditions
- External auditors' latest management letter
- Problem areas noted in prior year's audit
- Sensitive matters
- Internal auditors' reports

Audit Scope in Light of Current Business Circumstances

- Accounting and auditing developments
- Significant changes in company activities
- Changes in accounting policies
- Audit timing
- Locations to be examined
- Personnel being assigned to the audit
- Work to be done by the internal auditors
- Involvement of other auditors
- Planned reliance on internal accounting controls, including computer security programs
- Use of computer auditing techniques
- Areas for special procedures
- Review for fraud or other improprieties
- Rotation of audit procedures
- Estimated audit fees
- Proposed non-audit services
- Comparison of operating results with prior year

Action

Approve audit plan, internal audit scope and non-audit services.

Report to Board

Discuss any problems carried over from the prior year; describes cope and timing of the audit; highlight all significant matters affecting the financial statements; describe non-audit services to be provided by the external auditors; and conclude whether such services could impair independence.



Pre-Earnings Release Meeting

Timing

At or near completion of the audit and before the earnings release.

Meeting Objectives

To review the audit findings and the draft of the annual stockholders' report.

Review of Audit

- Deviations from audit plan
- Accounting and auditing developments
- Difficulties or delays
- Significant matters and discoveries
- Restrictions encountered
- Unresolved matters
- Disagreements with management

- Significant audit adjustments and those waived because of immateriality
- Independence issues

Review of Preliminary Draft of Financial Statements, Form 10-K and Auditors' Report

- The auditors' responsibility under generally accepted auditing standards
- The quality, not just the acceptability, of accounting principles followed by the company and any changes from the prior period
- Management judgments and accounting estimates
- Significant audit adjustments made or waived
- Other information in documents containing the audited financial statements

- Completeness of disclosures, including risks and uncertainties
- Consistency of annual report text with financial statements
- Wording of auditors' report – qualifications or modifications
- Timing of release

Action

Approve audit findings, earnings release and preliminary draft of annual financial statements.

Report to Board

Discuss conduct of the audit; report problems; discuss any disagreements between external auditors and management; and recommend release of earnings and clear draft of financial statements.

Post-Release Meeting

Timing

After release of financial statements and receipt of external auditors' management letter.

Meeting Objectives

To review the year's work; recommend improvements in internal controls; approve internal audit plan for coming year; and recommend external auditors for the coming year.

Review of Internal Controls

- External auditors' management letter recommendations
- Internal auditors'

recommendations and audit plan for next year

- Management's assessment of internal controls and suggested changes

Performance Review

- Evaluation of external auditors by:
 - Management
 - Internal auditors
- Retrospection on prior year's quarterly reviews and audit to determine how to improve efficiency and effectiveness
- Evaluation of internal auditors and staff by external auditors
- Evaluation of financial and accounting personnel by external auditors
- Recommendations from all

parties for improvements in audit approach and financial disclosure

- Review of auditors' fees
- Self-assessment of audit committee and review of charter

Action

Recommend improvements in internal controls, approve internal audit plan for the coming year and recommend external auditors.

Report to Board

Summarize the year's work; recommend changes in internal controls or accounting methods; and recommend external auditors for the coming year.



Illustrative Audit Committee Charter

Committee Role

The committee's role is to act on behalf of the board of directors and oversee all material aspects of the company's financial reporting, control and audit functions, except those specifically related to the responsibilities of another standing committee of the board. The audit committee's role includes a particular focus on the qualitative aspects of financial reporting to shareholders and on company processes for the management of business/financial risk and for compliance with significant applicable legal, ethical and regulatory requirements.

The role also includes coordination with other board committees and maintenance of strong, positive working relationships with management, external and internal auditors, counsel and other committee advisors.

Committee Membership

The committee shall consist of at least three, and no more than six, independent, non-executive board members. Committee members shall have: (1) knowledge of the primary industries in which the company operates; (2) the ability to read and understand fundamental financial statements, including a company's balance sheet, income statement, statement of cash flows and key performance indicators; and (3) the ability to understand key business and financial risks and related controls and control processes. The committee shall have access to its own counsel and other advisors at the committee's sole discretion.

At least one member, preferably the chair, should be literate in business and financial reporting and control, including knowledge of the regulatory requirements, and should have past employment experience in finance or accounting or other comparable experience or background. Committee appointments shall be approved annually by the

full board upon recommendation of the nominating committee. The committee chairperson shall be selected by the committee members or by the nominating committee.

Committee Operating Principles

The committee shall fulfill its responsibilities within the context of the following overriding principles:

Communications

The chair and others on the committee shall, to the extent appropriate, maintain an open avenue of contact throughout the year with senior management, other committee chairs and other key committee advisors (external and internal auditors, etc.), as applicable, to strengthen the committee's knowledge of relevant current and prospective business issues.

Education/Orientation

The committee, with management, shall develop and participate in a process for review of important financial and operating topics that present potential significant risk to the company. Additionally, individual committee members are encouraged to participate in relevant and appropriate self-study education to ensure understanding of the business and environment in which the company operates.

Annual Plan

The committee, with input from management and other key committee advisors, shall develop an annual plan responsive to the "primary committee responsibilities" detailed herein. The annual plan shall be reviewed and approved by the full board.

Meeting Agenda

Committee meeting agendas shall be the responsibility of the committee chair, with input from committee members. It is expected that the chair would also ask for management and key committee



advisors, and perhaps others, to participate in this process.

Expectations and Information Needs

The committee shall communicate committee expectations and the nature, timing and extent of committee information needs to management, internal auditors and external parties, including external auditors. Written materials, including key performance indicators and measures related to key business and financial risks, shall be received from management, auditors and others at least one week in advance of meeting dates. Meeting conduct will assume committee members have reviewed written materials in sufficient depth to participate in committee/board dialogue.

External Resources

The committee shall be authorized to access internal and external resources, as the committee requires, to carry out its responsibilities.

Meeting Attendees

The committee shall request members of management, counsel, internal and external auditors, as applicable, to participate in committee meetings, as necessary, to carry out the committee's responsibilities. Periodically and at least annually, the committee shall meet in private session with only the committee members. It shall be understood that either internal or external auditors, or counsel, may, at any time, request a meeting with the audit committee or committee chair with or without management's attendance. In any case, the committee shall meet in executive session separately with internal and external auditors, at least annually.

Meeting Frequency

The committee shall meet at least quarterly. Additional meetings shall be scheduled as considered necessary by the committee or chair.

Reporting to the Board of Directors

The committee, through the committee chair, shall report periodically, as deemed necessary, but at least

semiannually, to the full board. In addition, summarized minutes from committee meetings, separately identifying monitoring activities from approvals, shall be available to each board member at least one week prior to the subsequent board of director's meeting.

Self-Assessment

The committee shall review, discuss and assess its own performance as well as its role and responsibilities, seeking input from senior management, the full board and others. Changes in role and/or responsibilities, if any, shall be recommended to the full board for approval.

Committee Responsibilities

Financial Reporting

- Review and assess the annual and interim financial statements before they are released to the public or filed with the SEC.
- Review and assess the key financial statement issues and risks, their impact or potential effect on reported financial information, the processes used by management to address such matters, related auditors' views, and the basis for audit conclusions.
- Approve changes in important accounting principles and the application thereof in both interim and annual financial reports.
- Advise financial management and the external auditors that they are expected to provide a timely analysis of significant current financial reporting issues and practices.

Risks and Controls

- Review and assess the company's business and financial risk management process, including the adequacy of the overall control environment and controls in selected areas representing significant risk.
- Review and assess the company's system of internal controls for detecting accounting and financial reporting errors, fraud and defalcations, legal violations, and noncompliance with the corporate code



of conduct. In that regard, review the related findings and recommendations of the external and internal auditors, together with management's responses.

- Review with legal counsel any regulatory matters that may have a material impact on the financial statements.
- Review the results of the annual audits of directors' and officers' expense accounts and management perquisites prepared by the internal auditors.

External and Internal Auditors

- Recommend the selection of the external auditors for approval by the board of directors.
- Instruct the external auditors that they are responsible to the board of directors and the audit committee as representatives of the shareholders. In that regard, confirm that the external auditors will report all relevant issues to the committee in response to agreed-upon expectations.
- Review the performance of the external and internal auditors.
- Obtain a formal written statement from the external auditors consistent with standards set by the Independence Standards Board. Additionally, discuss with the auditors any relationships or non-audit services that may affect their objectivity or independence.
- Consider, in consultation with the external and internal auditors, their audit scopes and plans to ensure completeness of coverage, reduction of redundant efforts and the effective use of audit resources.
- Review and approve requests for any consulting services to be performed by the external auditors, and be advised of any other study undertaken at the request of management that is beyond the scope of the audit engagement letter.

- Review with management and the external auditors the results of the annual audits and related comments in consultation with other committees as deemed appropriate, including any difficulties or disputes with management, any significant changes in the audit plans, the rationale behind adoptions and changes in accounting principles, and accounting estimates requiring significant judgments.
- Provide a medium for the external auditors to discuss with the audit committee their judgments about the quality, not just the acceptability, of accounting principles and financial disclosure practices used or proposed to be adopted by the company.
- Approve changes in the directors of the internal audit function.
- Instruct the internal auditors that they are responsible to the board of directors through the committee.
- Review with the internal auditors any changes in the scope of their plans.
- Review with the internal auditors the results of their monitoring of compliance with the code of conduct.

Other

- Review and update the committee's charter.
- Review and update the company's code of conduct.
- Review and approve significant conflicts of interest and related party transactions.
- Conduct or authorize investigations into any matters within the committee's scope of responsibilities. The committee will be empowered to retain independent counsel and other professionals to assist in conducting any investigation.