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Information Advisory

July 22, 2002

Proposed Changes to Audit Committee Functions and Standards

Part 3 of a Series from the Corporate Group

This Advisory is the third in our series dealing with proposed and pending changes to regulations affecting public companies. This Advisory focuses upon proposed changes affecting the role, composition and compliance of corporate audit committees contained in the various proposals set forth in recent weeks by the New York Stock Exchange ("NYSE"), The Nasdaq Stock Market ("Nasdaq"), the Business Roundtable and the Council of Institutional Investors (the "Council"). In summary, the proposals (i) stress the need for an audit committee comprised entirely of independent directors, (ii) narrow the definition of "independent director" for audit committee membership, and (iii) outline specific functions of the audit committee to be included in a written charter.

Please refer to our **Corporate Responsibility Redefined** Advisory for information on how proposed rules become enacted through action by the Securities and Exchange Commission (the "SEC"), Congress or the self-regulatory organizations.

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IN THIS ADVISORY

NYSE RECOMMENDATIONS

The NYSE's Corporate Accountability and Listing Standards Committee (the "NYSE Listing Committee") has proposed changes to the NYSE's current listing requirements which, if adopted by the NYSE Board of Directors, will be sent to the SEC for approval. The following is a summary of the recommended changes that will specifically affect corporate audit committees of NYSE-listed companies.

ABOUT US

McKenna Long & Aldridge is a full-service law firm of nearly 400 lawyers and public policy advisors with offices in Atlanta, Denver, Los Angeles, Philadelphia, San Diego, San Francisco, Washington, DC and Brussels. Formed June 1, 2002 through the merger of Long Aldridge & Norman LLP and McKenna & Cuneo L.L.P., the firm provides business solutions in the areas of corporate law, government contracts, intellectual property and technology, complex litigation, public policy and regulatory affairs, real estate, environmental, energy and finance.

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Independence of Audit Committee Members

- The audit committee must have at least three members;
- The audit committee must be comprised entirely of independent directors;
- For a director to be deemed "independent," the director must meet the independence standards described in our July 17, 2002 Advisory entitled "Changes in Composition and Operation of Boards of Directors of Public Companies", including the Board of Directors' affirmative determination that the director has no material relationship with the listed company other than as a director;
- The basis for the determination that a director serving on the audit committee has no material relationship with the listed company must be disclosed in the company's proxy statement;
- An audit committee member may receive only director's fees as compensation from the listed company;
- An audit committee member who holds 20% or more of the listed company's stock (or who is a general partner, controlling shareholder or officer of such a holder) cannot chair the committee or vote; and
- The audit committee chair must have accounting or related financial management expertise, as defined in Section 303.01(B)(2) of the NYSE Listed Company Manual. Such expertise requires that the chair (i) be financially literate, as determined by the board, or become financially literate within a reasonable time and (ii) have accounting or related financial management experience, as determined by the board.

Purpose of the Audit Committee

The audit committee's purpose must be set forth in a written charter. The Committee's purpose must be, at a minimum:

- To assist board oversight of (i) the company's financial statements, (ii) compliance with legal and regulatory requirements, (iii) the outside auditor's qualifications and independence and (iv) the performance of the company's internal audit function and outside auditors; and
- To prepare the report in the annual proxy statement filed with the SEC.

Responsibilities of the Audit Committee

The duties and responsibilities of the audit committee must also be set forth in its charter. The committee must, at a minimum:

- Have the authority to hire and fire the company's outside auditor (subject to shareholder ratification, if applicable) and have the sole authority to approve all engagement fees and terms;
- At least annually, review a report by the outside auditor describing
  - The firm's internal quality control procedures;

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  - Any material issues raised by the most recent quality-control review, peer review or government or professional investigation, within the preceding five years, of the company's independent audits, and steps taken to deal with these issues; and
  - Relationships between the outside auditor and the company to assess the outside auditor's independence.
- Discuss annual audited financial statements with management and the outside auditors;
- Discuss, amongst themselves, earnings releases and financial information and earnings guidance provided to analysts and rating agencies, for which the committee may retain legal, accounting and other advisors without prior board approval;
- Discuss, amongst themselves, the company's risk assessment and risk management policies;
- Meet separately with management, internal auditors and outside auditors at least quarterly; and
- Review with the outside auditor any problems and management's response to those problems.

The audit committee should consider whether the company is receiving high-quality audits and whether rotation of the auditor would be helpful for the company. The committee should also consider adopting policies for hiring employees or former employees of the outside auditor.

NASDAQ RULES AND PROPOSALS

On May 22, 2002, the Board of Directors of Nasdaq approved several changes to existing Nasdaq rules, and on May 23, 2002, the revised rules were submitted to the SEC for approval. If approved as submitted, the following changes would be implemented for Nasdaq-listed companies:

Independence of Audit Committee Members
The definition of "independent director," which currently prohibits directors from receiving more than $60,000 annual compensation from the company (other than for board service, retirement plan benefits or non-discretionary compensation) will be narrowed further to provide that the following directors are not independent:

- Directors who receive more than $60,000 annual compensation from the company, including political contributions (the existing exceptions will remain intact), in the current or previous fiscal year;
- Directors who have a family member that received such compensation, in the current or previous fiscal year; or
- Any director who is a partner in, or a controlling shareholder or executive officer of, an organization, including a non-profit entity, if the company makes payments to the organization that exceed the greater of $200,000 or five percent of either the company's or the organization's gross revenues, in the current or any of the three (3) previous fiscal years.

Related-Party Transactions
The audit committee or other comparable body of the board must review and approve all related-party transactions. These include transactions in which any of the following persons has a direct or indirect material interest: a director or officer of the company, a nominee for director, an owner of more than 5% of the outstanding shares of any class of stock of the company or an immediate family member of any of the foregoing persons.

Disclosure of Audit Opinions with Going Concern Qualifications
Nasdaq-listed companies must disclose by immediate press release the receipt of an audit opinion with a going concern qualification.

THE BUSINESS ROUNDTABLE'S PRINCIPLES OF CORPORATE GOVERNANCE

In May 2002, the Business Roundtable released its Principles of Corporate Governance, which were influential in shaping the NYSE proposed rules. The following is a summary of those recommendations that relate specifically to corporate audit committees:

Audit Committee Members

- Each company should have an audit committee comprised solely of independent directors.
  - Determinations of director independence should be made by the company's board of directors, which should examine both the fact and the appearance of a director's independence;
  - The board should examine all relationships between the director and the company or its management which could impair, or appear to impair, the director's judgment, including familial, employment and business relationships as well as close personal relationships with senior management; and
  - The board should evaluate, on a case-by-case basis, whether a director's affiliation with a non-profit, non-affiliated organization to which the company makes contributions affects a director's independence.
- Audit committee members should meet minimal financial literacy standards, and at least one member should have accounting or financial management expertise; and
- Members should understand the corporation's business and risk profile, and be able to critically evaluate issues for which the committee is responsible.

Responsibilities
The audit committee must perform, at a minimum, the following responsibilities:

- Oversee the company's management and risk assessment practices;
- Evaluate the company's outside auditor and recommend the selected auditor to the board;
  - The audit committee should engage in an annual due diligence review of the outside auditor's qualifications, work product, independence and reputation; and
  - The committee should make its selection and determine whether the outside auditor should periodically rotate its senior personnel or whether the company should periodically rotate outside auditors based upon the committee's assessment of what will lead to the most effective audits.
- Review the company's critical accounting judgments and estimates, internal controls, compliance with the law and code of ethics, financial statements and internal audit function and personnel, and discuss these with the outside auditor or with management, as appropriate;
- Communicate with the board, the outside auditor and internal auditors and hold discussion with independent financial and legal advisors as needed; and
- Formulate a hiring policy for former employees of the outside auditor.

Meetings

- The audit committee should meet regularly, generally four or more times a year, with management and internal and outside auditors.
- The committee should also meet with the internal and outside auditors, without management present, at every meeting.

COUNCIL OF INSTITUTIONAL INVESTORS

On April 15, 2002, the Council, an organization of approximately 250 pension funds and investment related firms responsible for more than $2 trillion of pension assets, issued a report to the NYSE which included recommendations for modifications to the existing NYSE listing standards. What follows is a summary of the Council's recommendations relating to corporate audit committees:

Audit Committee Independence

- The audit committee should consist solely of independent directors, and the current exception for the inclusion of non-independent directors under "exceptional and limited circumstances" should be removed.
- A director should be excluded from the definition of "independent" if he or she:
  - Is now or during the past five years has been employed by the company or its affiliates in an executive capacity;
  - Is now or during the past five years has been employed by or has had more than a 5% ownership interest in a significant customer or supplier of the company;
  - Has had a personal services contract with the company or with any executive officer of the company in the past five years;
  - Has accepted compensation from the company other than for board service or benefits under a tax-qualified retirement plan;
  - Has an immediate family member who is currently or during the past five years has been employed by the company or its affiliates;
  - Is a partner, controlling shareholder, or executive officer of any for-profit business organization to which the company has made or from which the company has received significant payments;
  - Is an employee, officer or director of a non-profit organization that receives significant contributions from the company; or
  - Is an executive of another corporation where any of the company's executives serves on that corporation's compensation committee.

ACTIONS COMPANIES CAN TAKE NOW

The corporate audit committee has come under increased scrutiny in the turmoil of the current financial market, and it is expected to play a key role in monitoring the accuracy, quality and completeness of a company's financial statements and accounting practices. The audit committee provides an important check on the management and its accounting practices, by insuring that corporate financial information is correct and accurately reflects the company's financial performance and condition. The NYSE Listing Committee and Nasdaq proposed rule changes are intended to strengthen the independence and effectiveness of corporate audit committees.

As noted above, the NYSE Listing Committee's proposals await action by the NYSE Board of Directors. If adopted by the NYSE Board, the proposals will be presented to the SEC for approval, just as Nasdaq's proposals are being presented to the SEC for approval. Because we anticipate that the SEC will adopt the proposals in some form, we believe that there are a number of actions that companies should undertake at this time to prepare for the changes that will be mandated when the proposals are adopted.

- Compare qualifications of audit committee members to listing proposals for your company.
- Modify audit committee guidelines to incorporate any appropriate changes.
- Request that the audit committee have a special meeting with the company's management and with its outside auditors to review the company's financial reports (specifically the most recent Form 10-K and subsequent Form 10-Q report).
- Consider a press release and a posting on the company website following this review to reassure investors both as to the quality of the company's financial procedures and the condition of the company's financial statements

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