

WACHTELL, LIPTON, ROSEN & KATZ

# AUDIT COMMITTEE GUIDE

MARTIN LIPTON  
PAUL VIZCARRONDO  
ERIC S. ROBINSON  
DAVID C. KARP  
LAWRENCE S. MAKOW  
UMUT ERGUN  
JEFFREY UNGER



## *Preface*

Few responsibilities in corporate governance may look more daunting at this moment than that of service on the audit committee of a public company. But perhaps no form of governance service is more important or valuable. Congress, the Securities and Exchange Commission, the New York Stock Exchange, NASDAQ and the Public Company Accounting Oversight Board have placed greater responsibilities on—and displayed significant confidence in—the audit committee and its members. Among other things, the audit committee is now expected to monitor the integrity of the company’s financial statements and internal controls, the qualifications and independence of the company’s independent auditor, the performance of both the company’s internal audit function and its independent auditor and compliance by the company with legal and regulatory requirements. As a result, the audit committee today plays a crucial part in reassuring investors that corporate governance represents an effective system for controlling large public companies, for enhancing companies’ ability to create value and for fairly and completely reporting their financial results to investors and others.

To assist those who serve on the audit committee with their special role, this Guide provides an overview of the key rules applicable to audit committees of NYSE- and NASDAQ-listed companies and a reminder of the best practices that audit committees should consider. In addition, attached as exhibits are a Model Audit Committee Charter for New York Stock Exchange-listed companies, a Model Audit Committee Charter for NASDAQ-listed companies, a Model Audit Committee Preapproval Policy, Model Whistleblower Procedures, a Model Audit Committee Member Financial Expertise and Independence Questionnaire, as well as Model Policies and Procedures with respect to Related Person Transactions. These models are just that—models that can and should be adapted by a company to fit its own circumstances.

In today’s regulatory climate, the audit committee must be vigilant not only in monitoring financial reporting and compliance, but also in following appropriate procedures in performing its duties. It is incumbent upon every audit committee to ensure that its policies and procedures are “state of the art.” We hope that this Guide will assist audit committees in doing so.

Martin Lipton  
July 2004 / *updated* April 2008



## *About this Guide*

This Guide provides an overview of the key rules applicable to audit committees of NYSE- and NASDAQ-listed U.S. companies and best practices that audit committees should consider in the current environment. This Guide outlines an audit committee member's responsibilities, reviews the composition and procedures of the audit committee and considers important legal standards and regulations that govern audit committees and audit committee members. Although generally geared toward directors who are members of a public company audit committee, this Guide also is relevant to members of an audit committee of a private company, especially if the private company may at some point consider accessing the public capital markets.

In particular, this Guide is written to help audit committee members fulfill their duties in the current environment. To this end, this Guide proposes specific practices designed to promote effective audit committees. A well-run audit committee—*i.e.*, an audit committee composed of financially knowledgeable, independent members who are focused on the right areas of inquiry and intent on asking tough questions of management, internal audit and the independent auditor—can assist the company in its financial reporting and compliance obligations.

A few necessary caveats are in order. This Guide is not intended as legal advice, cannot take into account particular facts and circumstances and does not generally address individual state corporation laws. That said, we believe this Guide will offer directors sound guidance in terms of the general rules and practices that audit committee members should follow.

### *About the Exhibits*

The exhibits to this Guide include sample charters, policies and procedures. All of these exhibits are to some extent useful in assisting the audit committee in performing its functions and in monitoring compliance. However, it would be a mistake to simply copy published models. The creation of charters and written policies and procedures is an art that requires experience and careful thought. In order to be “state of the art” in its governance practices, it is not necessary that a company have everything another company has. When taken too far, a tendency to expand the scope of charters, procedures and policies can be counterproductive. For example, if a charter or procedure requires review or other action and the committee has not taken that action, the failure may be considered evidence of lack of due care. Each company should tailor its own audit committee materials, limiting charters and written procedures to what is truly necessary and what is feasible to accomplish in actual practice. These materials should be carefully reviewed each year to prune unnecessary items and to add only those items that will in fact help directors in discharging their duties.

## *Acknowledgments*

The authors wish to thank their colleague David M. Silk for his insightful comments and Laura A. McIntosh for her assistance.

© 2008  
Wachtell, Lipton, Rosen & Katz  
All rights reserved.





## *Table of Contents*

Chapter 1: Audit Committee Oversight Duties .....	1
Chapter 2: Audit Committee Charter .....	9
Chapter 3: Audit Committee Meetings and Chairman.....	15
Chapter 4: Relationship with the Independent Auditor.....	19
Chapter 5: Prohibited Independent Auditor Activities and Preapproval Policy .....	27
Chapter 6: Internal Controls and Oversight Effectiveness.....	35
Chapter 7: Audit Committee Whistleblower Rules and Ethics Codes.....	41
Chapter 8: Audit Committee Report and Disclosure Obligations.....	45
Chapter 9: Audit Committee Membership.....	53
Chapter 10: Cautionary Note on Disclosures to Government Investigators .....	63
Chapter 11: Audit Committee Member Liability Issues .....	69
<i>Exhibit A</i> Model Audit Committee Charter for NYSE-listed Company .....	A-1
<i>Exhibit B</i> Model Audit Committee Charter for NASDAQ-listed Company ..	B-1
<i>Exhibit C</i> Model Audit Committee Preapproval Policy .....	C-1
<i>Exhibit D</i> Model Employee Complaint Procedures for Accounting and Auditing Matters.....	D-1
<i>Exhibit E</i> Model Audit Committee Member Financial Expertise and Independence Questionnaire .....	E-1
<i>Exhibit F</i> Model Policies and Procedures with respect to Related Person Transactions.....	F-1



## **Audit Committee Oversight Duties**

Since the New York Stock Exchange (NYSE) first mandated in 1978 that its listed companies appoint an audit committee of independent directors, the audit committee has played a leading role in corporate governance. That role is even more important today, given the duties that Congress, the Securities and Exchange Commission (SEC), the NYSE, The NASDAQ Stock Market (NASDAQ) and the Public Company Accounting Oversight Board (PCAOB) have placed on audit committees and their members in the past few years.

In large measure, the audit committee has become the principal means by which the board discharges its duty to monitor financial and disclosure compliance. Accordingly, boards should carefully select audit committee members and, to the greatest extent possible, be attuned to the quality of the audit committee's performance. In view of the audit committee's centrality to the board's duties of financial review, it also is important for a board as a whole to receive periodic reports from the audit committee and to be comfortable that the audit committee, the auditors and management are satisfied that the financial position and results of operations of the corporation are fairly presented in its financial reports.

No aspect of an audit committee's role is more vital than its oversight mandate. At a minimum, an audit committee is charged with assisting the board in its oversight of the following:

- the qualifications, independence and performance of an outside auditor;
- the performance of a company's internal audit function;
- the integrity of a company's financial statements; and
- a company's compliance with legal and regulatory requirements.

This Chapter focuses on key aspects of an audit committee's oversight duties and offers practices that an audit committee might find useful in performing its duties. Additional required functions of an audit committee are discussed in "Chapter 2: Audit Committee Charter."

### **Overseeing the Independent Auditor**

It is an audit committee's responsibility to select a company's independent auditor. An audit committee, in most instances, will not have the staff required to perform research and other preliminary steps, and, thus, an audit committee will depend to some extent on a company's financial reporting executives for information about independent auditor qualifications. However, the retention process should be organized to effectively signal that an independent auditor's client is the audit committee, not company management.

A careful review by an audit committee of an auditor's independence and competence, as well as the proposed audit plan, will highlight to the independent auditor the responsibilities of an independent auditor to an audit committee. The factors that an audit committee should evaluate in assessing an auditor's independence and competence are discussed in "Chapter 4: Relationship with the Independent Auditor."

An audit committee also should pay close attention to the audit fee and use the fee to measure and reward the scope of audit work. An audit committee should use proxy disclosures to benchmark the fee of the independent auditor against the fees of auditors of comparable companies. The idea is not necessarily to economize on the audit fee (although prudent use of a company's resources is always appropriate) but rather to spot an audit fee that seems low or high in relation to peer companies. A low fee may signal an inadequately thorough audit. A high fee may indicate inefficiency in the audit or even raise questions regarding an auditor's independence. An audit committee also should have in place procedures to keep track of evolving standards and best practices in this area, such as the PCAOB's independence and ethics rules, which impose general standards with respect to the independence of independent auditors, restrict the types of non-audit tax services that independent auditors may perform for their audit clients, and prohibit contingent fee arrangements for services independent auditors provide to their audit clients.

Finally, an audit committee should insist that the financial disclosures and the accounting judgments made in preparing financial statements have independent auditor support. An audit committee should indicate to the independent auditor that it will bring in other accountants or legal counsel to advise the audit committee if the directors are not satisfied with the performance of an independent auditor.

### **Supervising Internal Audit**

Each NYSE-listed company must have an internal audit function to provide management and the audit committee with ongoing assessments of a company's risk management processes and systems of internal control. Internal auditors, when carefully selected and appropriately managed, are a powerful safeguard against defects in financial controls or financial statements. For example, the whistleblower in the WorldCom situation was WorldCom's internal auditing department. It spotted questionable entries on the WorldCom's books, investigated in an environment in which senior financial officers reportedly tried to chill the investigation and reported the results to the chair of the audit committee. When apprised, the audit committee acted immediately. A strong, well-performing internal audit function also may help to moderate the fees of an independent auditor and to facilitate the independent auditor's audit of a company's internal controls required by Section 404(b) of the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) and currently governed by PCAOB's Auditing Standard No. 5 (discussed in "Chapter 6: Internal Controls and Oversight Effectiveness").

Although a company may choose to outsource the internal audit function to a third-party service provider other than its independent auditor, internal auditors typically are full-time employees and should have access to all of the inputs into a company's financial statements and risk assessments. It is important to keep in mind, however, that there are potential weaknesses that are inherent in the internal audit function because of the status of the internal auditors as employees. Thus, an audit committee should seek to insulate the internal audit from undue corporate pressures.

An audit committee also should take an active role in the selection and the evaluation of the performance of the internal auditor. First, although not required, an audit committee should have ultimate authority over the selection of the senior internal auditor. Second, an audit committee should be involved in performance reviews of the senior internal auditor and should review compensation levels and structures. In that connection, it should be noted that most forms of incentive pay tied to stock price, sales or other measures of financial performance potentially create a conflict of interest for an internal auditor.

An audit committee should meet regularly and privately with the internal auditor and satisfy itself that the internal auditor has direct access to the audit committee. An audit committee also should be comfortable that the internal audit staff is afforded, and avails itself of, the opportunity to stay professionally current.

### **Integrity of a Company's Financial Statements**

The fundamental responsibility for a company's financial statements and disclosures rests with management and the independent auditor. However, audit committee members must have the financial literacy to understand the company's financial reporting in order to pass appropriately on the adequacy of the company's financial statements and management's discussion and analysis (MD&A).

The complexity of the financial statements of large public companies makes it unlikely that audit committee members will be able to explain each transaction from an accounting perspective. Still, an audit committee should satisfy itself as to the business purposes, the appropriate accounting and the general risks associated with all major transactions. An audit committee should not hesitate to enlist the services of management and independent auditor, as well as any outside advisors in special situations where it deems necessary, to help describe for the audit committee—comprehensively and comprehensibly—the financial condition of the company and the likeliest scenarios for the future. A thorough presentation of a company's financial condition should be made by senior management to new directors as soon as possible after their election to the board.

In addition, an audit committee should discuss with the independent auditor the accounting principles and critical accounting policies and judgments made in connection with the preparation of the company's financial statements. An audit committee should discuss possible alternative accounting treatments whenever the independent auditor has either discussed these alternatives with management or believes that these alternative policies would better reflect the underlying economic transactions and values. An audit committee should understand the range of results that would follow if alternative accounting methods had been used and why the method chosen was appropriate.

These discussions with the independent auditor should include a period during which management is excused. During these executive sessions, explicit inquiry should be made concerning significant discussions between a company's CEO, CFO, treasurer, comptroller or other senior officers and the independent auditor. The NYSE has stated that an audit committee should review with the independent auditor any audit problems or difficulties encountered by the independent auditor and management's response. However, even when there have been no disagreements between the independent auditor and management,

an audit committee should inquire as to the nature and extent of issues that the independent auditor and management spent time discussing during the audit.

Understanding a company's financial condition also requires a thorough review of the risks the company faces. These risks include business risks, financial risks (such as risks posed by financial asset composition, derivative securities, structural financing contingencies and guarantees), legal risks and reputational risks. While a board as a whole has the responsibility to monitor such risks, the audit committee is one logical place to locate this responsibility as a primary matter, since most of these risks have financial statement implications and all of them have disclosure (especially MD&A) implications.

Where financial risks to which a company is exposed are highly sophisticated, such as those involving complicated derivative instruments or financial structures, the audit committee should require management and the independent auditor to explain the company's position to the audit committee in clear and concise terms. An audit committee should discuss with management a range of scenarios that could result from the company's exposures and the steps management has taken to prepare for each. An audit committee also should seek to ascertain whether these risks and plans are adequately described in the company's MD&A disclosure.

In addition, an audit committee should receive regular reports from the company's general counsel and/or the chief compliance officer as to the legal and regulatory risks facing the company. An audit committee should be comfortable that the company is adequately managing and, if appropriate, reserving for, these risks, and is receiving competent legal advice.

As a general practice, audit committee members are entitled to rely on presentations, reports and information provided by management, the internal auditor, the independent auditor, legal counsel and other advisors, absent a reason to doubt their competence or fidelity. Of course, if an audit committee discovers credible evidence to the contrary, it must be diligent in pursuing any concerns. The SEC regulations adopted under Sarbanes-Oxley require an audit committee to have the power to engage independent counsel and other advisors as it determines necessary to carry out its duties. A company also is required to provide appropriate funding to the audit committee to pay the independent auditor and any advisors employed by the audit committee, as well as the administrative expenses of the audit committee that are incurred in carrying out its duties. While it is important for an audit committee to be able to use this power in appropriate

circumstances, it is not necessary, and often counterproductive, for audit committees routinely, or reflexively, to retain separate advisors.

### **Compliance Oversight and Risk Management**

An audit committee is not required to be the sole body responsible for risk assessment and management, but it must discuss guidelines and policies to govern the process by which risk assessment and management are undertaken. Many companies, particularly financial companies, manage and assess significant portions of the risk they undertake in the normal course of business through processes other than the use of an audit committee. The processes these companies have in place should be reviewed in a general manner by the audit committee, but they need not be replaced or duplicated by the audit committee. An audit committee should discuss the company's major financial risk exposures and the steps management has taken to monitor and control such exposures. The risks that a company might face include business risks (such as risks posed by defective products, violation of environmental requirements, accidents and political changes), financial risks (such as risks posed by financial asset composition, derivative securities, structured financing contingencies and guarantees), legal risks and reputation risks. An audit committee should make inquiry as to whether each category of risk is adequately addressed by the company's risk-management procedures.

Audit committees of regulated financial institutions should understand the principal general risk areas being identified from time to time by regulators through supervisory letters, speeches, enforcement or supervisory actions involving peer institutions and the like, and understand how their institutions are positioned with respect to such risks. At many financial institutions, regulators work with company personnel on a daily basis, and an audit committee should satisfy itself that there is an adequate procedure in place to promptly alert senior management to problems or tensions that develop in that relationship.

An audit committee should meet regularly with the general counsel, including in executive session, to monitor compliance with legal and regulatory requirements. An audit committee should oversee an annual review of the company's compliance programs and its information and reporting systems and receive an opinion from the general counsel as to their adequacy. Where there is a serious investigation or litigation that is being handled by outside counsel, direct reports by such counsel to the board or the audit committee are desirable.



Audit committees of regulated financial institutions periodically should review the structure of the company's legal and regulatory compliance departments to assure proper lines of authority and reporting, as well as the structure of the conflict review function. Compliance officers should report to the audit committee periodically about the company's relationships with its regulators and its compliance with legal and regulatory rules, as well as with the company's internal codes of ethics, conduct and compliance (including disciplinary measures taken due to any failure to comply).

These meetings and reports should be designed to permit the audit committee to monitor the company's overall compliance program. Such monitoring is especially significant given that the U.S. Sentencing Commission has amended the Organizational Sentencing Guidelines to define more stringently the criteria for effective compliance programs and to place greater responsibility on directors and officers for the oversight and management of compliance programs. The federal sentencing guidelines promote comprehensive compliance procedures and careful monitoring by requiring that directors be knowledgeable about compliance programs, be informed by those with day-to-day responsibility over compliance and participate in compliance training. The guidelines also provide that an effective compliance program monitored by the board may be a mitigating factor in a prosecutor's decision whether or not to charge a company with wrongdoing.

An audit committee also should review the company's internal controls over financial reporting. This is now a critical area in light of Sarbanes-Oxley's mandate that a company's independent auditor conduct an audit of the company's internal controls. An audit committee's responsibilities for oversight of internal control over financial reporting and the SEC and PCAOB requirements are discussed in "Chapter 6: Internal Controls and Oversight Effectiveness."

### **Managing the Intersection of Management, Internal Audit and Independent Auditor**

An audit committee is a critical nexus among the independent auditor, the internal auditors and management. An audit committee must have direct, unmediated access to each of these three groups and be able to communicate in confidence with them. This permits an audit committee, in overseeing the performance of these three groups, to enlist the services of each in order to assist in monitoring the others. Thus, in separate meetings, each group should be encouraged to offer suggestions as to how the performance of the others can be improved.



## **Audit Committee Charter**

Both the NYSE and NASDAQ have specific rules regarding audit committee charters. Also, while not specifically requiring a charter, federal statutes and the rules of the SEC prescribe various specific responsibilities to audit committees. This Chapter discusses key aspects of such requirements.

### **NYSE Requirements**

The NYSE requires that each audit committee have a formal written charter, approved and adopted by the board. The audit committee charter must provide for an annual performance evaluation of the audit committee. It also is good practice for an audit committee to review and reassess the adequacy of its charter on a regular basis.

### **Specific Duties and Responsibilities**

An audit committee charter must set out in sufficient detail the specific duties and responsibilities of the audit committee. These specific duties derive in part from outside requirements, such as applicable statutes, the rules of the SEC and other relevant regulatory bodies, the NYSE's listing rules, and best practices derived from suggestions by accounting and other experts, and in part from internal requirements reflecting the company's particular business and corporate structure. These duties and responsibilities must include:

- Being directly responsible for the appointment, compensation, retention and oversight of the company's independent auditor (including resolution of financial reporting disputes between management and the auditor) for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the company, and ensuring the direct reporting relationship of the independent auditor to the audit committee. Companies still may seek shareholder approval or ratification of independent auditor selection, but the audit committee must be responsible for making the recommendation or nomination to shareholders.
- Obtaining and reviewing, at least annually, a report from the company's independent auditor describing such independent

auditor's internal quality-control procedures, any material issues raised by the most recent internal quality-control review or peer review of the firm, or by any inquiry or investigation by governmental or professional authorities within the past five years regarding an independent audit carried out by independent auditor, any steps taken to deal with such issues and (to assess the auditor's independence) all relationships between the independent auditor and the company.

- Meeting to review and discuss the annual and quarterly financial statements with management and the independent auditor (including the company's specific disclosures in MD&A).
- Discussing earnings, press releases, financial information and earnings guidance provided to analysts and ratings agencies.
- Discussing the company's policies with respect to risk assessment and risk management.
- Holding periodic mandatory executive sessions with each of management, internal auditors and independent auditor.
- Reviewing with the independent auditor any audit problems or difficulties (including any restrictions on the scope of the independent auditor's activities or on access to requested information, and any significant disagreements with management) and management's response. Among the items an audit committee may want to review with the independent auditor are:
  - any accounting adjustments that were noted or proposed by the independent auditor but were “passed” (as immaterial or otherwise);
  - any “management” or “internal control” letter issued, or proposed to be issued, by the independent auditor to the company; and
  - responsibilities, budget and staffing of the company's internal audit function.

- Having the authority to engage independent counsel and other advisors, and having appropriate funding to pay these advisors as well as the independent auditor and ordinary administrative expenses incurred in the course of carrying out its duties.
- Setting clear hiring policies for employees or former employees of the independent auditor, taking into account the pressures that may consciously or subconsciously exist for auditors seeking a job with the company they audit.
- Establishing procedures for receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, including procedures for the confidential, anonymous submission by employees of concerns about questionable accounting or auditing matters.
- Reporting regularly to the board.

Each NYSE issuer also should conduct an appropriate review of all related-party transactions required to be disclosed in the company's public filings for potential conflicts of interest on an ongoing basis and such transactions should be subject to the approval of the audit committee or a comparable body. See "Chapter 8: Audit Committee Report and Disclosure Obligations."

### **Model Audit Committee Charter for NYSE-listed Companies**

Attached as *Exhibit A* is a model audit committee charter for NYSE-listed companies. Note that this audit committee charter is only a model intended to reflect the requirements of an audit committee charter for a NYSE-listed company. Companies should customize the model to their particular needs and circumstances.

### **NASDAQ Requirements**

NASDAQ also requires that an audit committee have a formal written charter. In addition, NASDAQ requires that an audit committee review and reassess the adequacy of its charter on an annual basis.

### **Specific Duties and Responsibilities**

An audit committee charter must specify the scope of the audit committee's responsibilities, and how it carries out those responsibilities,

including structure, processes and membership requirements. These specific responsibilities derive in part from outside requirements, such as applicable statutes, the rules of the SEC and other relevant regulatory bodies, NASDAQ's listing rules, and best practices derived from suggestions by accounting and other experts, and in part from internal requirements reflecting the company's particular business and corporate structure. In particular, the charter must provide that the audit committee has:

- Responsibility for ensuring that the audit committee receives from the independent auditor a formal written statement delineating all of the relationships between the independent auditor and the company.
- Responsibility for actively engaging in a dialogue with the independent auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor.
- Responsibility for taking, or recommending that the full board take, appropriate action to oversee the independence of the outside auditor.
- The purpose of overseeing the accounting and financial reporting processes of the company and the audits of the financial statements of the company.
- Direct responsibility for the appointment, compensation, retention and oversight of the independent auditor (including resolution of disputes between management and the independent auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the company, and ensuring the direct reporting relationship of the independent auditor to the audit committee.
- Responsibility for establishing procedures for the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters, including procedures for the confidential, anonymous submission by employees of concerns about questionable accounting or auditing matters.
- Authority to engage independent counsel and other advisors.

- Appropriate funding to pay these advisors as well as the independent auditor and ordinary administrative expenses incurred in the course of carrying out its duties.

In addition, each NASDAQ issuer must conduct an appropriate review of all related-party transactions required to be disclosed in the company's public filings for potential conflict-of-interest situations on an ongoing basis, and such transactions should be subject to the approval of the audit committee or a comparable body. See "Chapter 8: Audit Committee Report and Disclosure Obligations."

### **Model Audit Committee Charter for NASDAQ-listed Companies**

Attached as *Exhibit B* is a model audit committee charter for NASDAQ-listed companies. Note that this audit committee charter is only a model intended to reflect the requirements of an audit committee charter for a NASDAQ-listed company. Companies should customize the model to their particular needs and circumstances.





## **Audit Committee Meetings and Chairman**

An audit committee must meet sufficiently often to address its duties and should devote adequate time to planning the timing, agenda and participants of its meetings. The minimum number of meetings that an audit committee should hold annually is four. The precise number of meetings an audit committee should hold depends upon various factors, including the scope of the audit committee's responsibilities and the size and business of the company. Neither the SEC nor the major securities markets have specific guidelines in this regard, although the NYSE requirement that an audit committee meet to discuss the company's annual and quarterly financial statements effectively means that an audit committee must meet at least quarterly.

The SEC requires that the proxy statement disclose the number of audit committee meetings held during the prior fiscal year as well as the name of any director who attended fewer than 75% of the aggregate number of meetings of the full board and the committees on which such director served.

### **Regular Meetings**

An audit committee should meet prior to the filing of the company's quarterly and annual reports to discuss the proposed disclosures in such reports and related earnings announcements. Note that an audit committee's responsibility to discuss earnings releases, as well as financial information and earnings guidance, may be fulfilled in a general manner (*i.e.*, through discussion of the types of information to be disclosed and the type of presentation to be made). An audit committee need not discuss in advance each earnings release or each instance in which a company may provide earnings guidance. After each of these meetings, an audit committee should meet separately with each of management, the independent auditor and the internal auditors, and in executive session.

In addition to reviewing a company's financial information and reports, the audit committee should annually discuss the audit plan and the performance, retention and compensation of the independent and internal auditors. The factors an audit committee should evaluate in assessing the independent auditor's independence and competence are discussed in "Chapter 4: Relationship with the Independent Auditor."

An audit committee also should schedule time to address its other responsibilities, including oversight over the functioning of internal controls, risk assessment guidelines and review of related-party transactions. See “Chapter 6: Internal Controls and Oversight Effectiveness.” Management and the independent auditor should bring to the attention of the audit committee any significant deficiencies in or problems with the company’s internal controls and any steps that have been taken to remedy these deficiencies and problems. An audit committee also should be apprised of complaints from whistleblowers or communications from regulatory agencies regarding the company’s accounting, internal controls or auditing matters. See “Chapter 7: Audit Committee Whistleblower Rules and Ethics Codes.”

In light of the audit committee’s increased responsibilities, audit committee meetings, like board meetings, have become longer and more substantive than was common practice before the enactment of Sarbanes-Oxley and related reforms. Many companies now schedule their audit committee meetings for the day prior to full board meetings to permit adequate time to consider and discuss agenda items.

### **Audit Committee Meeting Minutes**

Audit committees typically prepare minutes of their meetings (other than their executive sessions). It is common and prudent practice for such minutes to identify the topics discussed at the meetings rather than attempt to include detailed summaries. Enough information should be recorded, however, to establish that the audit committee sought the information it deemed relevant, reviewed the information it received and otherwise engaged in whatever actions and discussions it deemed appropriate in light of the then-known facts and circumstances. It bears emphasis that courts and regulators frequently regard minutes as the best record of what happened at a board or committee meeting. As a result, audit committee minutes should reflect the substance of the discussions at audit committee meetings and the time the audit committee spent on significant issues, and make clear reference to the documents that were furnished to the directors before and after the audit committee meeting. If there were significant discussions with or among directors prior to or after the audit committee meeting, consideration should be given to making appropriate reference to them in the minutes. Drafts of minutes should be prepared promptly after the audit committee

meeting and circulated promptly to the directors involved in the audit committee meeting.<sup>1</sup>

An audit committee should provide a report or a copy of the minutes of each audit committee meeting to the full board (see “Chapter 8: Audit Committee Report and Disclosure Obligations”). Directors who do not serve on the audit committee should have the opportunity to ask the audit committee questions, including about financial reporting, audit process, internal controls and other matters relating to the audit committee’s responsibilities or the topics covered at audit committee meetings. Some audit committees also prepare an annual report to the full board, summarizing the audit committee’s activities, conclusions and recommendations of the prior year and the proposed agenda for the upcoming year.

### **Audit Committee Chairman**

While the effectiveness of an audit committee turns on the diligence and energy of each of its members, an audit committee chairman has a special role. An audit committee chairman is responsible for ensuring that audit committee meetings run efficiently and that each agenda item receives the appropriate level of attention. An audit chairman also is often the key contact between the audit committee and the other board members, senior management, internal audit and the independent auditor.

In choosing an audit committee chairman, the board should seek to select a director with leadership skills, including the capability of forging productive working relationships (among committee members and with other board members, senior management, internal audit staff and the independent auditor). An audit committee chairman often is an audit committee financial expert (see “Chapter 9: Audit Committee Membership”). No matter who is appointed audit committee chairman, as part of the annual review of the audit committee, the audit committee and the board should review the combination of talents, knowledge and experience of audit committee members to assure that the audit committee has the right mix.

---

<sup>1</sup> In one Delaware decision, *In re Netsmart Technologies, Inc. Shareholders Litigation*, C.A. 2563-VCS (Mar. 14, 2007), Vice Chancellor Leo Strine criticized the common practice of providing drafts of board and committee meeting minutes to directors for approval a substantial (several months, in the case in question) period of time after the meeting. In the words of Vice Chancellor Strine, this practice is “to state the obvious, not confidence-inspiring.”

### **Consideration of Additional Compensation for Audit Committee Members and Chairman**

The enhanced time commitment implied by the current regulatory environment may require additional compensation for directors, and this pressure will be greatest with respect to service on the audit committee. Although there are reasons that would support a judgment not to discriminate in compensation among directors (*e.g.*, concerns that greater compensation for audit committee members could create or exacerbate a feeling on the part of other directors that financial disclosure and statements in MD&A are not really their responsibility but that of others who are paid more to deal with them), reasonable additional fees for audit committee members are legal and may be appropriate. Additional compensation for committee chairs is another way to give fair compensation for those most burdened with responsibilities. In most public companies, the compensation committee reviews the compensation for board members, including directors serving on audit committees.

## **Relationship with the Independent Auditor**

### **Enhanced Auditor Independence Rules and the Public Company Accounting Oversight Board**

To fulfill the mandates of Sarbanes-Oxley regarding auditor independence, the SEC, in 2003, issued rules to strengthen auditor independence and require additional disclosures to investors about the services provided by a company's independent auditor.

In addition, as part of the effort to enhance the integrity of financial disclosures by public companies, Sarbanes-Oxley created the PCAOB. Every public accounting or audit firm that prepares, issues or participates in the preparation or issuance of audits must register with the PCAOB, including non-U.S. accounting or audit firms that audit non-U.S. companies listed in the United States or that otherwise file reports with the SEC.

The PCAOB is the primary regulator of independent public accounting firms. Sarbanes-Oxley grants the PCAOB the authority to (1) adopt auditing, quality control, ethics, independence and other standards relating to the preparation of audit reports, (2) enforce the applicable SEC and PCAOB requirements, and (3) conduct inspections and, where needed, investigations of public accounting or audit firms registered with the PCAOB.

### **Audit Committee Oversight of Auditor Independence and Performance**

An audit committee must make a specific inquiry about an auditor's independence and competence. An audit committee should present its conclusions with respect to an independent auditor to the full board.

### **Independence Inquiry**

Ensuring compliance with the SEC's auditor independence requirements is of obvious importance given that a public company must have its financial statements and internal controls audited by an "independent" auditor.

As a general matter, the SEC will not recognize an auditor as independent *vis-à-vis* an audit client if the auditor is not capable of exercising objective and impartial judgment on all issues encompassed within the auditor's engagement. In determining whether or not this standard has been met, the SEC will consider

all relevant circumstances, including all relationships between the accountant and the audit client, focusing on whether any such relationship: (1) creates a mutual or conflicting interest between an auditor and the audit client; (2) places an auditor in the position of auditing its own work; (3) results in an auditor acting as management or as an employee of the audit client; or (4) places an auditor in a position of being an advocate of an audit client.

As part of the inquiry concerning an auditor's independence, an audit committee should examine carefully the scope of work that the independent auditor has undertaken for the company and the value of, and fees attributable to, that work. An independent auditor also should be vetted carefully for any relationships that might be perceived as affecting its independence, such as the presence of its alumni, or relatives of its employees, on a company's audit committee or among a company's senior financial staff, as well as any financial or other business relationships between an independent auditor, and a company or its officers, directors or substantial shareholders. Provision of certain non-audit services to a company or services to members of an audit committee or to a company's senior executives also may impair the independent auditor's independence. See "Chapter 5: Prohibited Auditor Activities and Preapproval Policy."

#### *Employing Members of the Independent Auditor*

Under the SEC rules, a company's auditor will not be independent if a current partner or professional employee of the auditor is employed by the company or serves on its board. In addition, the employment by a company, in an accounting or financial reporting oversight role,<sup>2</sup> of a close family member of (1) any person on the audit engagement team or with supervisory authority over the audit, (2) any other partner or managerial employee of the independent auditor who has provided at least ten hours of non-audit services to the company during the audit engagement period or who expects to provide at least ten hours of non-audit services to the company on a recurring basis or (3) any partner from the

---

<sup>2</sup> The SEC defines a person in a "financial reporting oversight role" as someone who is in a position to, or does, exercise influence over the contents of the financial statements and related information, including MD&A, or anyone who prepares such statements or information. This would include a director, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer or any equivalent position. The SEC takes the position that every member of an audit engagement team is subject to this one-year "cooling-off" period prior to working in any such position for the audited company or any of its subsidiaries.

same office in which the lead audit partner primarily practices in connection with the audit automatically will cause the auditor not to be considered independent.

An auditor's independence also will be impaired if the company employs a former partner or professional employee of the audit firm in an accounting or financial reporting oversight role if the former partner or professional employee maintains some influence over the independent auditor's operations or financial policies, has a capital balance remaining in the independent auditor or has a financial arrangement with the independent auditor (other than certain fixed payments, such as pursuant to a retirement plan).

In addition, under the PCAOB's independence rules, ongoing discussions between a company and a member of its audit engagement team (or an individual in a position to influence the audit engagement) over potential future employment of such individual by the company taints the auditor's independence. Such individuals must be removed immediately from the audit engagement and the independent auditor then must review such individual's work during the audit engagement. While the PCAOB standard is directed at independent auditors (rather than their clients), public companies should be mindful of this standard and exercise care in approaching any member of their independent auditors about the possibility of employment with the company. It is advisable for companies to establish procedures company personnel must abide by before approaching, and during discussions with, members of the independent auditor about the possibility of employment with the company. As noted in "Chapter 2: Audit Committee Charter," the charter of an NYSE-listed company's audit committee must charge the audit committee with the responsibility to set clear hiring policies for employees or former employees of the independent auditor.

A one-year "cooling-off" period is required before members of an audit engagement team for a public company can accept employment with that company in a "financial reporting oversight role." The cooling-off period runs from the date such individual last served on the audit engagement team until one year after the date the company files its annual financial statements for the period in which such individual served on the audit engagement team. In other words, the restriction would require that the independent auditor complete one annual audit subsequent to when the conflicted individual served on the audit engagement team.

### *Compensation for Non-Audit Engagements*

Under the SEC rules, the independence of an auditor automatically is compromised if, at any point during an engagement period, any audit partner receives compensation (including indirectly, such as through allocation of equity shares in the audit firm) based on the audit partner procuring engagements with the audit client to provide non-audit services.

### *Rotation of Audit Partners*

One other important aspect of auditor independence is the auditor's partner rotation and other staffing and personnel policies. For each client of a registered public accounting firm, both the lead and concurring audit partners must be rotated at least once every five years, with a five-year cooling-off period thereafter. Audit partners who are not lead or concurring partners must be rotated every seven years, with a two-year cooling-off period thereafter. The SEC interprets the rotation requirements as covering tax or other specialty partners who serve as the "relationship" partner for a company and have a high level of contact with its management and its audit committee.

There is no requirement that the independent auditor itself be rotated, although the NYSE recommends that each audit committee consider whether, in the interest of assuring continuing auditor independence, there should be regular rotation of the independent auditor.

If a change in independent auditor is being considered, an audit committee should review:

- any disagreements within the past three years between the company's senior financial management and the current independent auditor regarding accounting and financial statements;
- any consultations within the past three years between a company and a proposed new auditor regarding the application of accounting principles; and
- whether, in seeking an engagement, a proposed new auditor has proposed a change in accounting principles, or the manner in which the company has been doing business, which would result in a material increase in reported revenues or earnings or in a material change in assets or liabilities.



*Business Relationships between the Company and the Independent Auditor*

Other than the provision of professional services, an independent auditor is restricted from having any direct business relationship with the company or its officers, directors and substantial shareholders. This restriction extends to

- all members of the audit engagement team;
- any partner or employee with supervisory authority over the audit (including senior members of the outside auditors);
- any other partner or managerial employee who has provided at least ten hours of non-audit services to the company during the audit engagement period or who expects to provide at least ten hours of such services on a recurring basis; or
- any partner from the same office in which the lead audit engagement team partner primarily practices in connection with the audit. Indirect business relationships can also destroy independence if they are material.

Certain financial relationships between an auditor and a company will also destroy independence under SEC rules. Specifically, an independent auditor, including (1) any member of the audit engagement team, (2) any partner or employee with supervisory authority over the audit (including senior members of the independent auditors), (3) any other partner or managerial employee who has provided at least ten hours of non-audit services to the company during the audit engagement period or who expects to provide at least ten hours of such services on a recurring basis, (4) any partner from the same office in which the lead audit engagement team partner primarily practices in connection with the audit or (5) an immediate family member of any of the foregoing individuals, cannot have any direct investment in the company, such as stocks, bonds, notes, options or other securities. In addition, a company and its officers or directors cannot lend to or borrow from its independent auditor or from any of the foregoing individuals referred to in the preceding sentence.

**Competence Inquiry**

When assessing an independent auditor's competence, an audit committee should pay particular attention to:

- the independent auditor's expertise in the company's industry;
- the education and experience of the key partners on the audit team and any partners who are expected to replace them in the near future under the partner rotation requirements;
- if a company has significant operations outside the United States, information with respect to an independent auditor's offices or affiliates in the relevant countries;
- the scope, plan and staffing of the independent auditor's audit and attestation services, including whether the proposed staffing and fees are adequate and appropriate relative to the scope of the work contemplated; and
- any recent inquiries or investigations of an independent auditor by governmental or professional regulators, whether an independent auditor is subject to any orders or consent decrees of the SEC, PCAOB or other regulator, material settlements, adjudications of liability or other involvement in notable private litigation, as well as any other material reputational issues.

An audit committee also should make inquiry as to whether an independent auditor's registration with the PCAOB and its annual reports and other recent materials filed with the PCAOB are in good order.

It also is good practice for an audit committee to assess an independent auditor's leadership and integrity. Such an assessment should focus on the performance of the audit partners, whether the audit team is able to work effectively with and challenge management, the independent auditor's compliance with the partner rotation requirements and the possible impact of such rotation on the quality of the independent auditor's services. The evaluation of the lead partner of the independent auditor should take into account the opinions of management and a company's internal auditors.

Evaluating competence also requires an assessment of an independent auditor's system of internal controls and procedures. To satisfy itself that those procedures are adequate, an audit committee should consider how the independent auditor resolves technical issues, including the roles of the reviewing partner and the national office; the results of the most recent peer review and PCAOB inspection of the independent auditor; the independent auditor's recent record

with respect to restatements and changes in previously issued audit reports; and any information regarding any other complaints that the independent auditor has received and its response to such complaints.

### **Communications between Independent Auditor and Audit Committee**

SEC rules also mandate that independent auditors make specific disclosures to audit committees of the companies they are auditing. Prior to the filing of its audit report with the SEC, an independent auditor must report to a company's audit committee:

- all critical accounting policies and practices to be used;
- the alternative GAAP-compliant accounting treatments available for material items that have been discussed with management, including a discussion of the different impact of management's versus the independent auditor's preferred treatment; and
- any material written communication between the independent auditor and management (such as any management letter or schedule of unadjusted differences).

These communication requirements imposed on an independent auditor also enhance an audit committee's oversight responsibility vis-à-vis an independent auditor.

In addition, PCAOB Auditing Standard No. 5 requires an independent auditor, prior to issuing its report on a company's internal controls over financial reporting, to communicate in writing to the audit committee and management all material weaknesses. In addition, an independent auditor must communicate all significant deficiencies to the audit committee and communicate to management all deficiencies (and inform the audit committee when that communication has been made) in internal controls identified during an audit. Also, under both the PCAOB standard and Section 10A of the Securities Exchange Act of 1934, as amended (Exchange Act), an independent auditor has obligations to inform the appropriate level of management and assure that the audit committee is adequately informed if possible fraud or other illegal acts are detected during the audit.

An audit committee should also review with the independent auditor key audit focus areas as well as items that may require special procedures during the audit. Any findings of an independent auditor regarding such special audit

procedures should be reviewed with an eye toward recommending any appropriate modifications of corporate policies and procedures.

### **Avoiding Improper Influence of an Independent Auditor**

Acting on the direction of Section 303 of Sarbanes-Oxley, the SEC has made more robust the protections against improper influence of independent auditors. Directors and officers are expressly prohibited from taking any action, direct or indirect, to coerce, manipulate, mislead or “fraudulently influence” any public accountant engaged in an audit of a company’s financial statements if they know or should have known that their action, if successful, could result in rendering the company’s financial statements false or materially misleading. Some examples of prohibited actions include: actions taken to lead an independent auditor to issue or reissue a report that is not warranted in the circumstances; actions taken to prevent an independent auditor from performing audit procedures required by generally accepted auditing standards or from withdrawing an issued report; or actions taken to obstruct an independent auditor’s communication of matters to a company’s audit committee. The SEC has taken the position that the rule, which is enforceable only by the SEC and not through a private right of action, may be violated by merely negligent behavior and that intent to defraud is not required—although the SEC does not intend the rule to reach honest and reasonable mistakes or to be triggered by active debate regarding auditing and accounting issues. The prohibition covers not only directors and officers, but any other person acting under the direction of an officer or director, whether or not directly supervised or controlled by such director or officer. Thus, potential liability under this rule extends to include customers, vendors, creditors, attorneys, securities professionals and other advisors, as well as other partners or employees of the independent auditor on which improper pressure is being exerted.

## **Prohibited Independent Auditor Activities and Preapproval Policy**

Sarbanes-Oxley and the SEC rules promulgated thereunder impose a number of restrictions regarding the services that an independent auditor is permitted to provide to its audit clients without tainting its independence. These restrictions, as well as recommended preapproval policies and procedures for permitted services, are discussed in this Chapter.

### **Prohibited Independent Auditor Activities**

#### ***SEC Auditor Independence Rules***

Under the SEC's auditor independence rules, independent auditors are significantly limited in the types of additional services they can perform for a company. Under the rules, the independence of an auditor will be impaired if, at any point during the audit and professional engagement period, the independent auditor performs any of the following services for a company:

- Bookkeeping and other services related to accounting records or financial statements, unless it is reasonable to conclude that the results of these services would not be subject to audit procedures during an audit of a company's financial statements.
- Financial information systems design and implementation (*e.g.*, managing a company's local area network(s) or designing or implementing a hardware or software system that aggregates source data underlying the financial statements or generates information that is significant to the financial statements or other financial information systems taken as a whole), unless it is reasonable to conclude that the results of these services would not be subject to audit procedures during an audit of the financial statements.
- Appraisal or valuation services, fairness opinions or contribution-in-kind reports, unless it is reasonable to conclude that the results of these services would not be subject to audit procedures during an audit of the financial statements.

- Actuarial services that involve the determination of amounts recorded in the financial statements and related accounts for a company, other than assisting company personnel in understanding the methods, models, assumptions and inputs used in computing an amount, unless it is reasonable to conclude that the results of these services would not be subject to audit procedures during an audit of the financial statements.
- Internal audit services, unless it is reasonable to conclude that the results of these services would not be subject to audit procedures during an audit of the financial statements.
- Management functions (*e.g.*, serving as a director, officer, employee or in any decision-making, supervisory or ongoing monitoring capacity).
- Human resources (*e.g.*, recruiting, testing and evaluation, reference checking, negotiation and referral services). However, an independent auditor is permitted, upon a company's request, to interview candidates and advise a company as to a candidates' competence for financial accounting, administrative or control positions.
- Broker-dealer, investment advisor or investment banking services.
- Legal services.
- Expert services unrelated to an audit, such as the provision of an expert opinion or other expert service for the purpose of advocating a company's interests in litigation or in a regulatory or administrative proceeding or investigation. For example, an auditor's independence would be impaired if the independent auditor were engaged to provide forensic accounting services to a company's legal counsel in connection with the defense of an investigation by the SEC Division of Enforcement. Additionally, an auditor's independence would be impaired if a company's legal counsel, in order to acquire the requisite expertise, engaged the independent auditor to provide such services in connection with a litigation, proceeding or investigation. However, an independent auditor is permitted to provide factual accounts (including in the form of testimony) of work performed or to explain positions taken

or conclusions reached during the performance of any service provided by the independent auditor.

The SEC also will consider an auditor's independence impaired if, at any point during the audit engagement period, the independent auditor provides any service or product for a contingent fee or a commission, or receives a contingent fee or commission from the audit client.

### ***PCAOB Rules***

In July 2005, the PCAOB adopted rules that expand the list of services an independent auditor is prohibited from providing to its audit clients without losing its independence. The rules were approved by the SEC and went into effect in 2006.

In particular, PCAOB rules prohibit an independent auditor from providing an audit client any non-audit service during the engagement period that relates to marketing, planning or opining in favor of the tax treatment of transactions that are (1) confidential transactions under Internal Revenue Service regulations or (2) "aggressive tax transactions," which the PCAOB defines as any transaction that was recommended initially by the independent auditor and a significant purpose of which is tax avoidance, unless the proposed tax treatment is at least more likely than not to be allowable under applicable tax laws. The PCAOB has made clear, however, that the prohibition on opining on aggressive tax transactions is limited to opining *in favor of* its tax treatment; it does not restrict an independent auditor from advising an audit client *not* to engage in an aggressive transaction. The PCAOB's rules also preclude independent auditors from providing tax services to members of management who have a financial reporting oversight role at the audit client or material affiliate of the audit client during the engagement period, or to their immediate family members. The rules provide a transition period for individuals who are hired or promoted into a financial reporting oversight role, which allows for tax services in process at the time of such hiring or promotion to be completed within 180 days.

Moreover, permitted tax services provided by independent auditors have to meet enhanced preapproval requirements under the PCAOB's rules. The rules require an audit firm to supply the audit committee with detailed documentation regarding the nature and scope of the tax service and any compensation arrangement or other agreement, such as a referral agreement or fee-sharing arrangements, between the independent auditor and any person (other than the audit client) with respect to the promoting, marketing or recommending of a

transaction covered by the service. In addition, the independent auditor would be required to discuss with the audit committee the potential effects of the service on the auditor's independence and document the substance of that discussion.

The PCAOB rules contain other restrictions, such as a prohibition on contingent fees, which overlap with the SEC's auditor independence requirements.

#### ***Cautionary Note on Internal Control-Related Services***

The provision of internal control-related services by an independent auditor to an audit client is a sensitive area. Given the independent auditor's audit of internal controls required by Section 404(b) of Sarbanes-Oxley, the provision of internal control-related services by an auditor carries with it the risk of compromising the independence of the independent auditor if the independent auditor's own work is the subject of audit procedures. As noted above, the SEC's independence rules prohibit a company's independent auditor from providing internal auditing services, such as those relating to internal accounting controls, financial systems or financial statements, unless it is reasonable to conclude that the results of these services would not be subject to audit procedures during an audit of the financial statements. The SEC has stated, however, that a company's independent auditor may assist management in documenting internal controls, *e.g.*, for purposes of assisting in the preparation of management's assessment of internal controls under Section 404(a) of Sarbanes-Oxley, but only if management is "actively involved"; management's acceptance of responsibility for the documentation and testing performed by the independent auditor will not, in and of itself, satisfy the SEC's auditor independence rules. Given the red flags that have been raised on this point by regulators, audit committees contemplating preapproving internal control-related services by an independent auditor need to be sure that there is a strong basis and record for doing so and that they clearly understand why this approach is more advisable than obtaining the same services from another source. As a matter of practice, most companies have opted to hire separate providers for internal control-related services.

#### **Independent Auditor Activities Requiring Audit Committee Preapproval**

Audit committees must approve in advance all audit services (including comfort letters in connection with securities underwritings) provided by an independent auditor, either specifically or in accordance with established policy



and procedures.<sup>3</sup> Similarly, independent auditors may provide non-audit services to their audit clients that are not specifically prohibited (including general tax planning and advice), but only if such services, like all audit services, are approved in advance by the audit committee (either specifically or in accordance with established policies and procedures).<sup>4</sup>

*Preapproval of permitted tax services:* As discussed above, PCAOB rules increase the responsibilities of an independent auditor and of an audit committee in preapproving tax services permitted to be provided by an independent auditor to its audit clients by requiring the independent auditor to supply the audit committee with written documentation of the scope of the proposed tax service and the fee structure for the engagement, discuss with the audit committee the potential effects of the performance of the service on the auditor's independence, and document the substance of that discussion.

*Preapproval of services related to internal controls:* AS No. 5 does not specifically require case-by-case preapproval of internal control-related non-audit services. However, as with the rules governing preapproval of permissible tax services, the rules require an independent auditor to supply the audit committee with a written description of the scope of the proposed service, discuss with the audit committee the potential effect of the proposed service on the auditor's independence and document the substance of that discussion in connection with the preapproval of any internal control-related non-audit services.

*De minimis exception for non-audit services:* There is a *de minimis* exception to the preapproval requirement for non-audit services aggregating less than 5% of an independent auditor's annual revenues from a company. The *de minimis* exception is available only if the services in question (1) were not recognized by the company at the time as non-audit services, (2) were promptly

---

<sup>3</sup> For purposes of the approval of both the external audit function and any non-audit services, the audit committee of a parent company may function as the audit committee of wholly owned subsidiaries that are also issuers for purposes of satisfying the preapproval requirements. In this situation, the subsidiary's disclosure should include the preapproval policies and procedures of the subsidiary as well as those of the parent company.

<sup>4</sup> Where a company has foreign subsidiaries that are audited by independent auditors that are members of the same network of international independent auditors as the company's principal independent auditor, any audit services performed by such member independent auditors for the company's foreign subsidiaries are subject to the preapproval requirements. Likewise, if the company's foreign subsidiaries are audited by independent auditors that are not members of the principal independent auditor's network, audit services performed for the company's foreign subsidiaries by such non-member independent auditors also are subject to the preapproval requirements. However, failure of an audit committee to pre-approve audit services to be provided by another independent auditor does not affect the independence of the principal auditor.

brought to the audit committee's attention, and (3) were approved by the audit committee prior to the completion of the audit and disclosed in the company's SEC filings. The *de minimis* exception applies only to non-audit services.

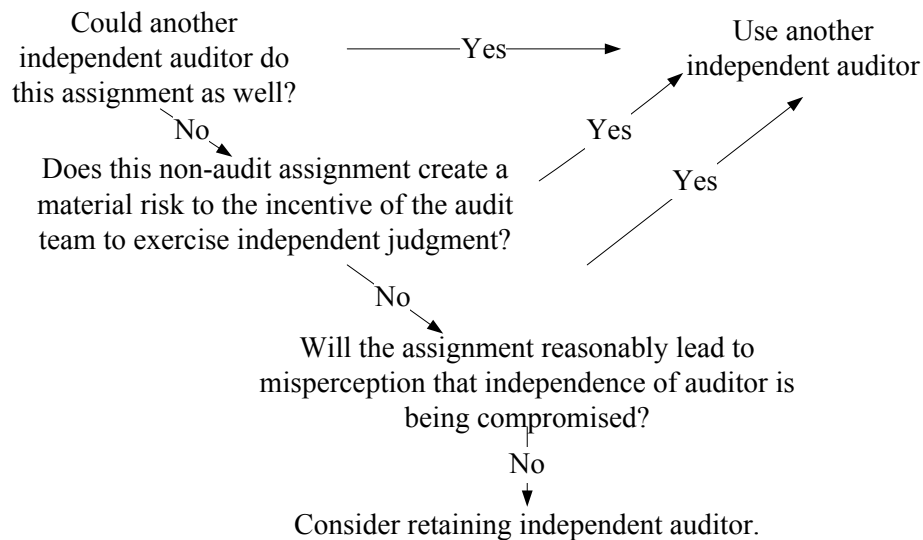
*Preapproval policies:* When using established policies and procedures (rather than case-by-case evaluation) to approve any services to be provided by an independent auditor, an audit committee must be especially mindful of the following constraints:

- Such preapproval policies and procedures must be detailed as to the particular services provided.
- Preapproval policies and procedures may not provide for broad, categorical approvals—for example, monetary limits may not be the only criterion for the preapproval. To give another example, licensing or selling income tax preparation software to an audit client is subject to audit committee review and may be preapproved as a permissible tax service so long as the functionality is limited to preparation of tax returns. However, if the software performs additional functions, each function should be evaluated separately for its potential effect on an auditor's independence.
- An audit committee must be informed about each service. In other words, preapproval policies must be designed to ensure that an audit committee knows precisely what services it is being asked to preapprove so that it can make a well-reasoned assessment of the impact of the service on an auditor's independence. Where applicable, requests for preapproval should be accompanied by detailed documentation regarding the specific services for which preapproval is being sought.
- Policies and procedures must not result in the delegation of an audit committee's authority to management. To satisfy this constraint, policies should be sufficiently detailed as to the particular services to be provided so that a member of management is not called upon to make a judgment as to whether a proposed service fits within the preapproved services.

*When bills materially exceed estimates, reapprove:* Where the fee for a preapproved service or group of services is materially in excess of the amount

estimated at the time of approval by an audit committee, the audit committee should specifically approve payment of such excess amount prior to payment of the excess amount.

*Control of non-audit assignments:* Ultimately, the audit committee must control all non-audit assignments given to an independent auditor that are not among the prohibited services discussed in this Chapter. With respect to any such assignment, an audit committee should ask the following questions:



### Model Audit Committee Preapproval Policy

Attached as *Exhibit C* is a model audit committee preapproval policy. Companies should customize the model to their particular needs and circumstances.



## **Internal Controls and Oversight Effectiveness**

Management is primarily responsible for designing and implementing internal control protocols. This includes establishing and maintaining adequate internal controls structures and procedures for financial reporting, evaluating the effectiveness of internal controls at least annually, identifying in a timely manner weaknesses and deficiencies in internal controls, taking appropriate corrective action where deficiencies or weaknesses exist, and notifying the independent auditor and audit committee of significant internal control deficiencies and any acts of fraud.

The specific responsibilities of an audit committee in this area will depend upon various factors. Most audit committees review the adequacy and effectiveness of a company's internal controls over financial reporting, the process for monitoring compliance with applicable regulations and laws, and any other legal matters that could have a significant impact on the company's financial reports. This Chapter focuses upon an audit committee's oversight of internal controls over financial reporting, as well as an audit committee's monitoring of the compliance and internal controls environment generally.

As part of its review of internal controls over financial reporting, an audit committee should satisfy itself that there is a proper system and allocation of responsibilities for the day-to-day monitoring of financial controls (and that the audit committee understands such system and allocation) but it should not seek to do the monitoring itself. An audit committee may obtain this understanding through reports and discussions with management, internal audit and an independent auditor. An audit committee also should understand the extent to which the internal and independent auditors review a company's internal controls protocols, including by understanding the material features of the audit plan of the independent auditor with respect to internal controls.

### **Audits of Internal Controls**

Reflecting the importance of effective internal controls, Section 404 of Sarbanes-Oxley and the SEC rules promulgated thereunder require public companies to include in their annual reports an assessment by management of the company's internal control over financial reporting, as well as an independent auditor's attestation report on the company's internal controls and financial reporting. Sarbanes-Oxley made clear that an independent auditor's attestation

under Section 404(b) must be based on the independent auditor's own audit of the Company's internal controls, and directed the PCAOB to adopt standards to govern that audit. Adopted pursuant to that mandate, PCAOB Auditing Standard No. 5 (AS No. 5) prescribes the standards by which an independent auditor must conduct the Section 404(b) audit of a company's internal control over financial reporting.

The PCAOB standard prescribing the procedures an independent auditor must abide by in conducting its Section 404(b) audit of internal controls is at least as significant a development for public companies as the SEC's rules under Section 404(a) of Sarbanes-Oxley regarding management reports on internal controls.

### **Definition of "Internal Control Over Financial Reporting"**

The SEC and the PCAOB define the term "internal control over financial reporting" as a process designed by, or under the supervision of, a company's principal executive and principal financial officers, or individuals performing similar functions, and effected by the company's board, management and other personnel, to provide "reasonable assurance" regarding the reliability of financial reporting and preparation of financial statements for external purposes in accordance with GAAP. Under the PCAOB's standards, "reasonable assurance" is a high level of assurance, but not absolute assurance—leaving room for the possibility that an audit conducted in accordance with the PCAOB standards may not detect a material weakness in internal controls or a material misstatement in the financial statements on a timely basis.

Internal control policies include those policies and procedures that:

- pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of a company;
- provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures of a company are being made only in accordance with authorizations of management and directors of the company; and
- provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of a

company's assets that could have a material effect on the financial statements.

### **Disclosure of Deficiencies Will Depend on Severity**

AS No. 5 uses the concepts of “deficiency,” “significant deficiency” and “material weakness” in grading the severity of internal control defects. Under AS No. 5:

- A “deficiency” exists when the “design” or “operation” of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements on a timely basis. A deficiency in “design” exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in “operation” exists when a properly designed control does not operate as designed, or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.
- A “significant deficiency” is a deficiency, or a combination of deficiencies, in internal controls that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of a company's financial reporting.
- A “material weakness” is a deficiency, or a combination of deficiencies, in internal controls such that there is a “reasonable possibility” that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis. There is a “reasonable possibility” of an event when the likelihood of the event is either “reasonably possible” or “probable” as those terms are used in Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*.

PCAOB Auditing Standard No. 5 requires an independent auditor, prior to issuing its report on a company's internal controls over financial reporting, to communicate in writing to the audit committee and management all material weaknesses. In addition, an independent auditor must communicate all significant deficiencies to the audit committee and must communicate to management all

deficiencies (and inform the audit committee when that communication has been made) in internal controls identified during an audit.

### **Compliance and Internal Controls Environment Generally**

In overseeing compliance with applicable laws and regulations and the integrity of the financial statements, an audit committee is encouraged to pay close attention to the compliance and internal controls environment generally. The U.S. Sentencing Commission, as well as the SEC, the United States Department of Justice (DOJ) and the PCAOB, have stressed the singular importance in this area of management's setting the right "tone at the top" and creating an organizational culture that encourages a commitment to compliance with law. To that end, an audit committee may wish to review with management:

- Is management setting the right tone at the top? How?
- Is there an appropriate supervisory and compliance structure?
- Is senior management's compliance message communicated throughout the organization?
- Is there a sophisticated understanding of the inventory of regulatory and reputational risks faced by the company's businesses?
- Is there an early warning system to identify and respond to emerging areas of regulatory focus?
- Is there specialized training for supervisors?
- Is information concerning regulatory and reputational risks and issues promptly surfaced to senior management and compliance personnel?
- Is internal discipline used effectively to reinforce the compliance message?

In addition, an audit committee should ask management to regularly update the audit committee on the company's overall internal controls protocols. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) set forth five interrelated elements of an effective internal control system: (1) control environment; (2) risk assessment; (3) control activities;



(4) information and communication; and (5) monitoring. Both the SEC and the PCAOB have endorsed the COSO elements as a suitable and appropriate framework for management's assessment over internal controls. Given the impact faulty internal controls can have on the integrity of the financial statements, an audit committee would be well served by reviewing how a company's control systems perform when measured against the five COSO elements.

In performing its monitoring function, an audit committee and the board should be sensitive to "red flags" and "yellow flags." When such warning signs appear, an audit committee should observe and investigate as appropriate and document its monitoring activities in minutes that accurately convey the time and effort directors devote to decision-making, even when the outcome is to take no action. Influential courts have indicated that directors may be held liable for lack of good faith in situations where they utterly fail, in "ostrich-like" fashion, to exercise *any* oversight. See "Chapter 11: Audit Committee Member Liability Issues." However, none of these cases contemplate director liability where directors use common sense and appropriate diligence in performing their oversight function. Directors remain fully protected by the business judgment rule when they make corporate decisions with the exercise of due care.



## **Audit Committee Whistleblower Rules and Ethics Codes**

### **Whistleblower Complaints and Procedures**

Under Sarbanes-Oxley, an audit committee must establish procedures for the receipt, retention and treatment of complaints received by a company regarding accounting, internal controls or auditing matters. Employees must be able to submit, on a confidential and anonymous basis, concerns regarding questionable accounting or auditing matters, or any deliberate or unintentional gaps in a company's internal controls. Since audit committees generally do not have their own staff, they will likely require the process of receiving and organizing complaints to be managed by internal or external legal counsel, the director of internal audit, the corporate secretary or another appropriate person.

Companies are subject to potential civil, and, in some cases, criminal, liability if they can be shown to have taken retaliatory action against a whistleblower who is an employee. In responding to this legal and regulatory environment, there can be a temptation to establish a special committee of independent directors to investigate every whistleblower complaint. This temptation should be resisted in favor of a procedure that filters whistleblower complaints, as such investigations can be extremely disruptive. Boards should inquire into whether an anonymous whistleblower hotline has been established by management and whether a well-documented policy for evaluating whistleblower complaints exists, but they should also be judicious in deciding which complaints truly warrant further action.

An audit committee should, at regular intervals, receive a summary of each complaint that has been submitted with respect to accounting, internal accounting controls or auditing matters, and discuss with management the necessary or appropriate steps to address any such complaint that is legitimate. Legal counsel or other outside advisors should be retained as needed to resolve any difficult issues. Management should inform an independent auditor of any changes made as a result of these complaints or any significant issues and their resolutions.

*Up-the-ladder Reporting by Attorneys.* Federal rules also require internal and outside lawyers for public companies to report, in certain circumstances, credible evidence that a material violation of securities laws or a breach of duty or similar violation by the company or any of its directors, officers, employees or

agents occurred, is occurring or is about to occur. To the extent an audit committee is determined to be the appropriate committee to receive any such reports, there should be a process in place for receiving, reviewing and responding to such reports. When in doubt, an audit committee should consult with counsel (including outside counsel, if appropriate) for advice.

*Whistleblower Procedures May Provide Early Warnings.* Effective whistleblower procedures can serve as an early warning system, alerting an audit committee to issues when they can be addressed and rectified without undue adverse consequences. The specific procedures will vary depending on what works best within a particular company, and the SEC does not mandate any particular set of procedures. In many cases, a general counsel will be the right initial person to receive and handle complaints and concerns on behalf of, and under the supervision of, the audit committee. Procedures should include a system for tracking the handling and disposition of complaints received and for assuring that there is no retaliation against individuals submitting complaints lawfully and in good faith.

*Civil Right of Action for Employees.* Sarbanes-Oxley also provides a civil right of action for employees of public companies who believe they have been discharged or subjected to other adverse employment action because they have provided information to supervisors or the government regarding conduct they reasonably believe to violate securities or antifraud laws.

### **Model Whistleblower Procedures**

To assist the audit committee, attached as *Exhibit D* are model whistleblower procedures. Companies should customize the model to their particular needs and circumstances.

### **Codes of Ethics**

An audit committee also may be asked to monitor compliance with the Sarbanes-Oxley rule that requires a company to disclose whether it has adopted a code of ethics for its CEO, CFO, principal accounting officer, controller or individuals performing similar functions (and if it has not adopted such a code, why not), as well as compliance with listing standards that mandate adoption of codes of conduct and ethics that apply to all directors, officers and employees.

The code of ethics contemplated by Sarbanes-Oxley and the code of conduct required by NASDAQ should include standards as are reasonably designed to deter wrongdoing and to promote honest and ethical conduct,

including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships, full, fair, accurate, timely and understandable disclosure in the company's SEC reports and other public communications, compliance with applicable governmental rules and regulations, prompt internal reporting of violations of the code to appropriate persons identified in the code and accountability for adherence to the code. The code of business conduct and ethics called for by the NYSE should address conflicts of interest, corporate opportunities, confidentiality, fair dealing, protection and proper use of company assets, compliance with laws, rules and regulations (including insider trading laws) and encouragement of the reporting of any illegal or unethical behavior.

Both the NYSE and NASDAQ require that any waivers given to directors or executive officers must be approved by the board (or, in the case of the NYSE, by the board or a board committee).



## **Audit Committee Report and Disclosure Obligations**

Under the rules of the SEC and major securities markets, there are several audit committee or audit committee-related disclosure obligations that must be complied with. Key obligations are discussed in this Chapter.

### **Audit Committee Report to the Board of Directors**

An audit committee is required to provide a report to the board recommending whether or not a company's audited financial statements should be included in the company's annual report on Form 10-K. This recommendation should be based on:

(1) the audit committee's review of, and discussions with management about, the financial statements;

(2) the audit committee's discussions with the independent auditor relating to matters required to be discussed by Statement on Auditing Standards No. 61; and

(3) the audit committee's discussions with the independent auditor regarding its independence and receipt of written disclosures and the letter from the independent auditor as required by Independence Standards Board Standard No. 1. The conversations with management should include discussions about the quality, not just the acceptability, of the accounting principles reflected in the financial statements, the reasonableness of significant judgments, and the clarity of disclosures in the financial statements.

A company's proxy statement must include a report from the audit committee discussing the audit committee's actions with respect to the foregoing. The name of each member of the audit committee must appear below such disclosure.

### **Audit Committee-Related Annual Report and Proxy Statement Disclosure Obligations**

An audit committee also should monitor a company's public filings to assure that the company is, as required, disclosing in its annual reports and proxy statements various items that relate to audit committees, including:

- whether the company has a separately designated audit (or functionally equivalent) committee and the identity of each committee member;
- whether or not the audit committee includes at least one member who is an “audit committee financial expert” (and, if not, why not), the individual’s name and whether he or she is independent under the listing standards of the company’s applicable securities market;
- the audit committee’s preapproval policies and procedures;
- the audit fees, audit-related fees, tax fees and all other fees billed by the independent auditor for each of the last two years (see also “Fee Disclosures Required” below); and
- if greater than 50%, the percentage of hours expended on the independent auditor’s engagement to audit the company’s financial statements for the most recent fiscal year attributable to work performed by persons other than the independent auditor’s full-time, permanent employees.

In addition, companies are required to disclose in proxy statements additional audit committee-related items, including:

- whether members of the audit committee are independent under applicable listing standards (and if the company is utilizing specific independence exemption(s));
- if a company does not limit to three or less the number of audit committees on which its audit committee members may serve, the board must determine and disclose that the service by an audit committee member on more than three audit committees would not impair his or her ability to serve effectively on the company’s audit committee; and
- whether a current copy of the audit committee charter is available on the company’s website, and, if so, provide the company’s website address. If a current copy of the audit committee charter is not available on the company’s website, a copy of the audit committee charter must be included as an appendix to the proxy statement at least once every three fiscal years and whenever the



audit committee charter has been materially amended since the beginning of the last fiscal year. If a current copy of the audit committee charter is not available on the company's website and is not being included in the company's proxy statement, the company must identify in which of the prior fiscal years the audit committee charter was so included.

### **Fee Disclosures Required**

Companies must disclose the fees paid to its independent auditors in the two most recent years, segregated into four categories:

- (1) audit fees;
- (2) audit-related fees;
- (3) tax fees; and
- (4) all other fees.

“Audit-related fees” are fees for assurance and related services by the principal accountant that are traditionally performed by the principal accountant and that are reasonably related to the performance of the audit or review of the company's financial statements. They include fees for employee benefit plan audits, due diligence related to mergers and acquisitions, accounting consultations and audits in connection with acquisitions, internal control reviews, attest services related to financial reporting that are not required by statute or regulation, and consultation concerning financial accounting and reporting standards. Fees for operational audit services are not related to the audit or review of the financial statements and should be included in “all other fees,” with a narrative description of such services. An audit committee should satisfy itself that the company is in compliance with the above requirements.

### **Audit Committee Should Satisfy Itself that Officer Certification Obligations Are Met**

In addition, an audit committee should take appropriate steps to satisfy itself that the company's CEO and CFO are meeting their obligations to the audit committee, the independent auditor and the public under the certification requirements established by the SEC, the company's securities market and Sarbanes-Oxley.

### **Section 302 and Section 906 Certifications**

Section 302 of Sarbanes-Oxley (Section 302) requires a company's CEO and CFO to certify in each quarterly and annual report that, among other things:

- based on their knowledge, the report is not misleading;
- based on their knowledge, the financial statements and other financial information included in the report fairly present, in all material respects, the financial condition and results of operations of the company;
- they are responsible for establishing and maintaining, and have performed certain specified tasks with respect to, the company's internal controls and disclosure controls and procedures; and
- they have disclosed to the audit committee and auditors all significant deficiencies and material weaknesses in the design or operation of internal controls, as well as any fraud that involves management or other employees with a significant role in the company's internal controls. The certifications must be filed as exhibits to the periodic reports. The CEO and CFO are required to sign separate Section 302 certificates; amendments to periodic reports that contain financial statements would require new certifications.

The certification required by Section 906 of Sarbanes-Oxley (Section 906) requires that each periodic report containing financial statements be accompanied by a statement by the company's CEO and CFO that (1) the report fully complies with the requirements of Section 13(a) or 15(d) of the Exchange Act; and (2) the information contained in the report fairly presents, in all material respects, the financial condition and results of operations of the company.

### **“Fairly Presents” Standard of Disclosure**

The CEO/CFO certification requirements have established a standard of financial disclosure above and beyond GAAP. The SEC states specifically that the standard of “fairly presents” is meant to be broader than GAAP. The fairly presents standard is meant to encompass the selection and proper application of accounting policies, the disclosure of financial information that is informative and reasonably reflects the underlying events, and the inclusion of other information necessary to give investors a materially complete picture of a company's financial

condition, results of operations and cash flows. The CEO, the CFO and all other company employees making accounting or disclosure judgments must base their decisions not just on GAAP but on the fairly presents standard. While it might be argued that this was always the case, it was not always the practice. Now it must be.

### **Non-GAAP Financial Information and Reconciliation to GAAP**

It also good practice for an audit committee to review any *pro forma* information released by the company. Under Sarbanes-Oxley, *pro forma*, or non-GAAP, financial information must be reconciled to GAAP in public disclosures. The SEC rules define a “non-GAAP financial measure” and specify that a company that presents material information including a non-GAAP financial measure also must present the most directly comparable GAAP financial measure and a reconciliation between the two. Although the rules do not place direct responsibility on an audit committee to ensure that a company’s disclosures comply with these regulations, an audit committee should oversee the process by which the company decides whether to present non-GAAP financial measures, and an audit committee should understand and approve the reasons for doing so. An audit committee should inquire as to whether any such disclosure adds to investors’ understanding of a company’s financial position rather than confuses or complicates the picture.

### **Management’s Reports on Internal Controls**

As noted earlier, Section 404 of Sarbanes-Oxley and the SEC rules adopted thereunder require management to report annually on a company’s internal controls over financial reporting. SEC rules also require management to make quarterly disclosures of any material changes in a company’s internal controls. While it is not the audit committee but management that is responsible for these disclosures, the audit committee will necessarily be involved in their development and should adequately monitor the related proposed disclosures. Also, if there is going to be disclosure that there have been material changes to internal controls over financial reporting during a quarter, the audit committee should inquire whether any significant deficiencies or material weaknesses underlying such changes are proposed to be specially disclosed, and, if it is determined that they will not be, ensure that this has been a properly considered decision and that there is a firm and reasonable basis for the decision not to disclose.

### **Related-Party Transactions**

There is nothing inherently improper about transactions between a company and its officers or directors; such transactions often are in the best interests of a company and its shareholders, offering efficiencies and other benefits that might not otherwise be available. It is entirely appropriate for an informed board, on a proper record, to approve such arrangements through its disinterested directors. An audit committee often serves this function.

As a matter of compliance and best practices, however, and particularly in the current environment, a company should give careful attention to all related-party transactions. Full disclosure of all material related-party transactions and full compliance with proxy, periodic reporting and financial footnote disclosure requirements is essential. Management should make sure that all related-party transactions have been fully and carefully reviewed with the board. A board should reevaluate a company's policies and procedures for reviewing such transactions on both an initial and ongoing basis, and for determining that all continuing related-party transactions remain in the best interest of the company.

Under SEC rules, disclosure must be made in a company's annual proxy and annual report on Form 10-K regarding any transaction, since the beginning of the company's last fiscal year, or any currently proposed transaction, in which the company was or is to be a participant and the amount involved exceeds \$120,000, and in which any related person (defined below) had or will have a direct or indirect material interest. Subject to certain exceptions, the following must be disclosed regarding any such transaction:

- the name of the related person and the basis on which the person is a related person;
- the related person's interest in the transaction, including the related person's position or relationship with, or ownership in, a firm, company or other entity that is a party to, or has an interest in, the transaction;
- the approximate dollar value of the amount involved in the transaction;
- the approximate dollar value of the amount of the related person's interest in the transaction (computed without regard to profit or loss);

- in the case of indebtedness, disclosure of the amount involved in the transaction must include the largest aggregate amount of principal outstanding during the period for which disclosure is provided, the amount thereof outstanding as of the latest practicable date, the amount of principal paid during the periods for which disclosure is provided, the amount of interest paid during the period for which disclosure is provided, and the rate or amount of interest payable on the indebtedness; and
- any other information regarding the transaction or the related person in the context of the transaction that is material to investors in light of the circumstances of the particular transaction.

Under SEC rules, a “related person” means any person who (1) at any time during the specified period for which disclosure is required, was a director (or nominee if disclosure is being presented in the company’s proxy statement) or executive officer; (2) any person covered by Item 403(a) of Regulation S-K who at the time of the transaction was a security holder of more than 5% of the company’s securities; or (3) or any immediate family member of the foregoing. An “immediate family member” means any child, stepchild, parent, stepparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law or sister-in-law, and any person (other than a tenant or employee) sharing the household of the director (or nominee), executive officer or security holder.

Under the SEC rules, a company must describe its policies and procedures for the review, approval or ratification of related-party transactions. While the rules acknowledge that a company’s policies and procedures will vary depending on the particular circumstances, the rules state that examples of such features may include, in given cases:

- the types of transactions that are covered by such policies and procedures;
- the standards to be applied pursuant to such policies and procedures;
- the persons or groups of persons on the board or otherwise who are responsible for applying such policies and procedures; and

- a statement of whether such policies and procedures are in writing, and, if not, how such policies and procedures are evidenced.

A company also must identify any related-party transaction since the beginning of the company's prior fiscal year where such policies and procedures did not require review, approval or ratification, or where such policies and procedures were not followed.

As noted above, the SEC rules mandate that companies disclose the persons or groups of persons on the board or otherwise who are responsible for applying the company's policies and procedures regarding related-party transactions. NASDAQ marketplace rules require, and the NYSE rules recommend, that an audit committee or another independent body of the board approve all related-party transactions. In light of this, a board should consider assigning to the audit committee or to another committee consisting solely of directors who are both independent and disinterested with respect to the transaction under consideration the job of reviewing any newly proposed related-party transactions. The committee should have the authority to hire such outside financial, legal and other advisors as it deems appropriate to assist it in its evaluation of such transactions. If a related-party arrangement is of material significance to a company, the board should consider whether additional steps are necessary to ensure that such transactions are properly monitored and evaluated. For example, a board should take active measures to determine that the entities providing related-party services are being held to the same standards the company would demand of unaffiliated third-party service providers and that there is a clear reason for procuring the service from a related party.

Attached as *Exhibit F* are model policies and procedures with respect to related-person transactions. Note that this is only a model for policies and procedures, and companies should customize the model to their particular needs and circumstances.

## **Audit Committee Membership**

### **Composition of the Audit Committee**

An audit committee must be composed solely of directors who meet the listing standards for director independence of the company's particular securities market, as well as the audit committee independence standards of the securities market as prescribed under the federal securities laws.

The major securities markets require a minimum of three members on an audit committee, and audit committees typically consist of three to five independent directors. In addition, mindful of the time commitment necessary to being an effective audit committee member, the NYSE discourages directors from serving on too many audit committees. Under the NYSE's listing standards, if a company does not limit to three or less the number of public company audit committees on which its audit committee members may serve, and if an audit committee member simultaneously serves on the audit committees of more than three public companies, then the board must affirmatively determine that such simultaneous service would not impair the ability of the director to serve effectively on the company's audit committee. This determination must be disclosed in the company's proxy statement. Every prospective audit committee member should evaluate carefully the existing demands on his or her time before undertaking this commitment.

### **Financial Literacy and Financial Expertise**

Audit committees should be comprised of individuals or members with sufficient understanding of the language of accounting and corporate finance to act as effective overseers of the integrity of a company's financial reporting process and its financial statements.

#### ***Financial Literacy***

The major securities markets require that each member of an audit committee be able to read and understand fundamental financial statements.<sup>5</sup>

---

<sup>5</sup> The NYSE permits members to become financially literate within a reasonable period of time after being appointed to an audit committee. The NASDAQ no longer does.

Under the NYSE listing standards, it is the board's duty to make a determination, in its business judgment, that each member of the audit committee is financially literate. The board's determination of financial literacy may be expressed: "*By reason of education or experience and in light of all of the factors of which the Board of Directors has become aware, it appears that [Name of Director] possesses such degree of financial literacy as is required to select and oversee the performance of the independent and internal auditors; to monitor the integrity of the Corporation's financial statements; and otherwise to faithfully execute the charter of the Audit Committee.*"

Members should be adjudged competent when they are selected and agree to serve. Companies should also provide audit committee members during their tenure with professional advice and continuing education in evolving audit committee concepts and responsibilities, including updates on important accounting, auditing, finance and legal developments.

### ***Financial Expertise***

The NYSE requires that at least one member of the audit committee have accounting or related financial management expertise as determined by the board in its business judgment. The expertise requirement generally is fulfilled by a background in finance that permits a board to conclude in good faith that the director is capable of understanding the most complex issues of accounting and finance that are likely to be encountered in the course of a company's business. The NYSE permits a board to presume that an individual who is an "audit committee financial expert" within the meaning of the SEC's rules (described in Section 3 below) has the requisite "accounting or related financial management expertise" to satisfy the NYSE's listing standards.

Under the NASDAQ rules, at least one member of an audit committee must have past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background that results in the individual's financial sophistication, including being or having been a CEO, CFO or other senior officer with financial oversight responsibilities. An individual who is an "audit committee financial expert" within the meaning of the SEC's rules is deemed to fulfill this latter requirement.

### ***Audit Committee Financial Expert***

Under the direction of Sarbanes-Oxley, the SEC issued rules requiring a public company to disclose in its annual reports (or annual proxy statements) whether any member of its audit committee qualifies as an audit committee



financial expert (as defined below), as determined by the board in its business judgment. If the board determines that there is at least one audit committee member who is a financial expert, then the company must disclose the name of at least one such member and whether such member is independent. If no audit committee member qualifies, then the company must state why its audit committee lacks a financial expert. If the board determines that the audit committee has more than one member who qualifies as a financial expert, the company may, but is not required to, disclose the names of those additional members. If a company does disclose the names of any such additional financial experts serving on the audit committee, it also must indicate whether they are independent.

The SEC regulations define an “audit committee financial expert” as an individual who has *all* of the following attributes:

- an understanding of GAAP and financial statements;
- the ability to assess the general application of GAAP in connection with accounting for estimates, accruals and reserves;
- experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that can reasonably be expected to be raised by the company’s financial statements, or experience actively supervising persons engaged in such activities;
- an understanding of internal controls and procedures for financial reporting; and
- an understanding of audit committee functions.

An individual must have acquired the five audit committee financial expert attributes listed immediately above through any one or more of the following:

- education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor, or experience in one or more positions that involve the performance of similar functions;

- experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;
- experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
- other relevant experience.

In addition to CFOs, chief accounting officers and public accountants, the SEC's definition enables many CEOs and people actively engaged in professions such as investment banking, venture capital investment and financial analysis to qualify as audit committee financial experts. The SEC noted, however, that the mere fact that a CFO reports to a CEO would not necessarily qualify the CEO as an audit committee financial expert unless the CEO engaged in active supervision of the CFO.

It is important to note that there should be no additional liability under federal law for an audit committee financial expert. An individual who is determined by a board to be an audit committee financial expert (a term that has special legal significance under the Securities Act of 1933, as amended) will not be deemed to be an *expert* for any purpose as a result of being so designated, and will not be subject to any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such individual as a member of the audit committee and board in the absence of such designation. Nor does the designation of a member of the audit committee as an audit committee financial expert alter or affect the duties, obligations or liability of any other member of the audit committee or the board. Although this safe harbor provision does not expressly apply to state laws, the SEC has stated that it did not believe the designation of a director as an audit committee financial expert would increase that individual's exposure to liability under state law.

### **Independence Criteria of the Major Securities Markets**

The major securities markets require the audit committees of all listed companies to consist *entirely* of independent directors (with a limited exception under NASDAQ rules, discussed below). All independent directors must be identified as independent in proxy disclosure. Both the NYSE and NASDAQ have adopted specific rules as to who can qualify as an independent director. The NYSE and NASDAQ independence rules are in addition to the audit committee

independence requirements imposed by the federal securities laws (discussed later in this chapter), and both the NYSE and NASDAQ explicitly require compliance with those independence requirements. Both markets require the boards of listed companies to make an affirmative determination, which must be publicly disclosed (along with the basis for such determination), that each director designated as “independent” has no material relationship with the company that would impair his or her independence. Such disqualifying relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others. However, ownership of a significant amount of stock, or affiliation with a major shareholder, should not, in and of itself, preclude the board from determining that an individual is independent. In addition, the revised listing standards of both the NYSE and NASDAQ set forth circumstances that constitute *per se* bars to a determination of independence.

As a general matter, a director will be viewed as independent only if the director is a non-management director free of any family relationship or any material business relationship, other than stock ownership and the directorship, with the company or its management, and has been free of such relationships for three years. The following relationships bar a director from satisfying the independence standards of the NYSE or NASDAQ, as applicable:

- the director is, or has been within the last three years, an employee<sup>6</sup> of the company or by any parent or subsidiary of the company;<sup>7</sup>
- an immediate family member of the director is, or has been within the last three years, an executive officer of the company or by any parent or subsidiary of the company;
- the director is a current partner (or employee, under the NYSE rules) of a firm that is the company’s external auditor (or internal auditor, under the NYSE rules);

---

<sup>6</sup> Both the NYSE and NASDAQ provide that former employment as an interim executive officer does not, in and of itself, disqualify a director from being considered independent following such employment. Under the NASDAQ rules, however, such interim employment cannot last more than one year. The NASDAQ rules stress, however, that the board still must consider whether such former employment would interfere with a director’s exercise of independent judgment in carrying out the responsibilities of a director.

<sup>7</sup> Both the NYSE and NASDAQ define “company” to include a parent or subsidiary in a consolidated group with the company.

- an immediate family member of the director is a current partner of a firm that is the company's external auditor (or internal auditor, under the NYSE rules);
- under the NYSE rules, an immediate family member of the director is a current employee of the company's internal or external auditor and participates in the firm's audit, assurance or tax compliance (but not tax planning) practice;
- the director or an immediate family member was within the last three years a partner or employee of a firm that is the company's external auditor (or internal, under the NYSE rules) and personally worked on the company's audit within that time;
- under the NYSE rules, the director or an immediate family member of the director is, or has been within the last three years, an executive officer of another company where any of the company's present executive officers at the same time serves or served on that other company's compensation committee;
- under the NASDAQ rules, the director or an immediate family member of the director is an executive officer of another entity where at any time during the past three years any of the executive officers of the issuer serve on the compensation committee of such other entity;
- under the NYSE rules, the director is a current employee, or an immediate family member of the director is a current executive officer, of a company that has made payments to, or received payments from, the company for property or services in an amount that, in any of the last three fiscal years, exceeds the greater of \$1 million, or 2% of such other company's consolidated gross revenues;
- under the NASDAQ rules, the director or an immediate family member of the director is a partner, controlling shareholder or an executive officer of any organization to which the company made, or from which the company received, payments for property or services in the current or any of the past three fiscal years that

exceed 5% of the recipient's consolidated gross revenues for that year, or \$200,000, whichever is more;<sup>8</sup>

- under the NYSE rules, the director or an immediate family member of the director has received during any 12-month period within the last three years more than \$100,000 in direct compensation<sup>9</sup> from the company (other than in director and committee fees and pension or other forms of deferred compensation for prior service (*provided* that such compensation is not contingent in any way on continued service) and compensation received by an immediate family member for service as a non-executive employee);<sup>10</sup>
- under the NASDAQ rules, the director or an immediate family member of the director received any compensation<sup>11</sup> from the company in excess of \$100,000 during any 12-month period within the last three years (other than director or committee fees, benefits under qualified retirement plans, or nondiscretionary compensation and payments received by an immediate family member for service as a non-executive employee);<sup>12</sup> and

---

<sup>8</sup> The NASDAQ excludes from the calculation payments arising solely from investments in the company's securities and payments under nondiscretionary charitable contribution matching programs.

<sup>9</sup> The NYSE focuses on direct compensation. Consequently, investment income from the company (such as dividend or interest income) would not count toward the \$100,000 threshold. In addition, the NYSE's focus on direct compensation means that *bona fide* and documented reimbursement of expenses also may be excluded. Note, however, that the NYSE considers payments to a director's solely owned business entity to be direct compensation.

<sup>10</sup> The NYSE also permits companies to exclude from the \$100,000 threshold compensation received by a director for former service as an interim executive officer of the company.

<sup>11</sup> Unlike the NYSE, the NASDAQ rule is not limited to direct compensation. Accordingly, even indirect compensation must be included in the calculation of the \$100,000 threshold. For instance, NASDAQ provides that political contributions to the campaign of a director or an immediate family member of the director would be considered indirect compensation and, as such, must be included for purposes of the \$100,000 threshold.

<sup>12</sup> The NASDAQ permits companies to exclude from the \$100,000 threshold compensation received by a director for former service as an interim executive officer of the company as long as such interim employment did not last longer than one year. The NASDAQ rules stress, however, that the board still must consider whether such compensation would interfere with the director's exercise of independent judgment in carrying out the responsibilities of a director.

- under the NASDAQ rules, the director participated in the preparation of the financial statements of the company or any current subsidiary of the company at any time during the past three years.

Independence determinations must be based on all relevant facts and circumstances. Thus, even if a director meets all the bright-line criteria set out above, a board is still required to make an affirmative determination that the director has no material relationship with the company. Under the NYSE rules, the principles underlying the determination of independence also must be publicly disclosed in the company's annual report or proxy statement. The NYSE rules also provide that the board may adopt and disclose categorical standards to assist it in making determinations of independence and may make a general disclosure if a director meets these standards. The company must disclose any such standard the board adopts. Any determination of independence for a director who does not meet such standards must be specifically explained. In addition, under the SEC disclosure rules, for each director that is identified as independent, the company must describe, by specific category or type, any transactions, relationships or arrangements (other than transactions already disclosed as related-party transactions) that were considered by the board under the company's applicable director independence standards (*e.g.*, the NYSE or NASDAQ independence rules).

Under the NASDAQ rules, one director who does not meet its independence criteria may be appointed to the audit committee if the board, under exceptional and limited circumstances, determines that membership on the audit committee by the individual is required in the best interests of the company and its shareholders, *provided* that:

- such individual meets the SEC's independence criteria (discussed below);
- such individual is not a current officer or employee or family member of an officer or employee;
- the board discloses, in the next annual proxy statement subsequent to such determination, the nature of the relationship and the reasons for that determination; and
- a member appointed under this exception serves no longer than two years and does not chair the audit committee.

### **Audit Committee Member Independence Standards under Federal Securities Laws**

In addition to the requirement that all members of an audit committee be independent as defined by the listing standards of the securities market(s) on which a company's securities are traded, audit committee members of public companies also must satisfy the special definition of audit committee independence set forth in Sarbanes-Oxley.

This special definition is, in some respects, more stringent than the major securities markets' definitions of director independence. Audit committee members may not directly or indirectly receive any compensation from the company—such as consulting, advisory or similar fees—other than their director fees, and may not be affiliates of the company. The affiliate disqualification covers any individual that directly, or indirectly through one or more intermediaries, controls, is controlled by, or is under common control with, the company. The prohibition on acceptance of compensatory fees precludes audit committee service if the company makes any such payments either directly to the director, or indirectly, to the director's spouse, minor child or stepchild, child or stepchild sharing a home with the director, or to law firms, accounting firms, consulting firms, investment banks or financial advisory firms in which the director is a partner, member, managing director, executive officer or holds a similar position.

### **Model Audit Committee Financial Expertise and Independence Questionnaire**

Attached as *Exhibit E* is a model audit committee financial expertise and independence questionnaire.

### **Getting Prospective or New Audit Committee Members Up to Speed**

Assuming they comply with the relevant independence and financial expertise requirements outlined in this Chapter, prospective and new audit committee members also should make sure they obtain whatever background information they deem appropriate. At a minimum, they will need to understand the duties and responsibilities of the audit committee, the expected time commitment, and an overview of the business and financials of the company. Prospective and new members also should comprehend the key risks, claims and litigation facing the company and its internal controls and financial reporting systems. Reviewing recent meeting books (given to audit committee members

prior to audit committee meetings) and minutes of the audit committee may prove helpful in this regard.

In particular, prospective or new audit committee members might consider asking the following questions:

- What are the company's main revenue sources?
- Are the company's public disclosures, especially regarding financial affairs and legal and regulatory compliance, clear, transparent and comprehensible?
- Can investors understand the company's governance structure?
- Who are the company's principal advisors and independent auditor and what are their roles?
- What are the audit committee's mandate and responsibilities as set forth in its charter?
- Who are the audit committee members and what are the procedures followed by the audit committee?
- What skills, knowledge or experience will I bring to the audit committee and what role is intended for me?

### **Term of Service**

There is no rule regarding length of audit committee service. When assessing how long a director should serve on the audit committee, the board needs to strike the right balance. An audit committee with high turnover may not be as effective as possible given the investment of time required of audit committee members to understand a company's business, financial and other relevant information. An audit committee with no or very low turnover risks losing the benefits and perspective that a new member might bring. To accommodate these competing goals, a board should consider periodically rotating qualified directors onto the audit committee.



## Cautionary Note on Disclosures to Government Investigators

### Audit Committees Must Be Apprised of Possible Material Illegal Acts

As a result of Sarbanes-Oxley and related regulatory initiatives, boards of directors—and especially audit committees —today increasingly are called upon to conduct internal investigations. Section 10A of the Exchange Act requires an independent auditor to inform the audit committee if, in the course of conducting an audit, the independent auditor becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the company) has or may have occurred. If the independent auditor subsequently determines that the illegal act has a material effect on the financial statements of the company and that the audit committee has not taken timely and appropriate remedial actions to address it, the independent auditor must report to the full board, which must immediately inform the SEC.

Section 10A was intended to be, in the words of one commentator, “a modest statute with limited significance.”<sup>13</sup> However, the SEC has adopted an aggressive interpretation of the statute’s application and its own enforcement authority thereunder, and independent auditors have responded with overly risk-averse behavior. Section 10A does create numerous interpretive difficulties for accounting firms, and, increasingly, independent auditors are resolving uncertainties on the side of requesting investigations. As a result, the requirements of Section 10A are becoming more burdensome to companies than Congress ever anticipated. It is becoming all too common for an independent auditor that finds an issue even remotely questionable to insist that the audit committee hire outside counsel to investigate. Such investigations may be an unnecessary waste of resources and time and in some cases have interfered with the progress of major corporate transactions, to the detriment of the company and its shareholders.

An audit committee that finds itself facing a request by the independent auditor to hire counsel and investigate a situation should not be afraid to use its own business judgment. Certainly, when circumstances appear to merit a thorough investigation, an audit committee should promptly commit adequate

---

<sup>13</sup> Thomas L. Riesenberg, Trying to Hear the Whistle Blowing: The Widely Misunderstood “Illegal Act” Reporting Requirements of Exchange Act Section 10A, 56 BUS. LAW. 1417, 1458 (2001).

resources and take all appropriate steps. Nonetheless, audit committee members should recognize the fact that independent auditors may go beyond the requirements of Section 10A in their eagerness to protect themselves from exposure, and directors, therefore, should consider carefully before bringing in outside counsel and conducting a large-scale investigation.

### **Reports to Government May Be Discoverable**

In responding to reports from independent auditors pursuant to Section 10A, and generally in responding to demands for internal investigations, directors should be mindful of the fact that any reports they make to government investigators regarding audit committee findings may be discoverable by plaintiffs in shareholder lawsuits. On the one hand, a company often will have good reasons for voluntarily sharing its findings with the DOJ, the SEC, state authorities or other regulators.<sup>14</sup> This, however, has to be weighed against the risk that voluntary reports to government investigators may later be subject to discovery by plaintiffs in parallel shareholder class actions or derivative litigation.

In the past, the pressure for companies to waive the attorney-client privilege stemmed in large part from the so-called “Thompson Memo—the 2003 DOJ document identifying the factors to be considered in determining whether to indict a company—which flatly made waiver of privilege a valid criterion for prosecutors to consider when assessing a company’s cooperation and culpability. In an apparent response to public outcry over the practice, the DOJ, on December 12, 2006, in a memo from Deputy Attorney General Paul J. McNulty, issued new guidance on the prosecution of companies that superseded the Thompson Memo. The policy continues to require prosecutors to consider a company’s “timely and voluntary disclosure of wrongdoing and its willingness to cooperate,” in determining whether to seek an indictment. However, the new principles state that corporate waiver of attorney-client and work-product protections “is not a prerequisite to a finding that a company has cooperated” and directs that such waivers may be requested only “when there is a legitimate need for the privileged information to fulfill . . . law enforcement obligations” and not when “merely desirable or convenient.” Prosecutors may seek “purely factual information,” such as attorney notes of witness statements or attorney-prepared chronologies or

---

<sup>14</sup> In an early indication that the pushback against this pressure to waive privilege is having some impact, the U.S. Sentencing Commission voted in April 2006 to delete language from the Organizational Sentencing Guidelines that had required companies to waive privilege in some instances to obtain cooperation credit. That amendment took effect on November 1, 2006 and should remove consideration of privilege waivers from the determination of whether an organization has cooperated sufficiently to earn a sentence reduction.

summaries of key events, from a company, but only after obtaining written approval by the U.S. Attorney, who is required to consult with the Assistant Attorney General for the Criminal Division. The McNulty Memo imposes additional restrictions when prosecutors seek legal advice or attorney work-product from a corporation. Such privileged information only may be sought in “rare circumstances” and after obtaining written authorization from the Deputy Attorney General. Moreover, if a company declines to provide such a waiver, “prosecutors must not consider this declination against the corporation in making a charging decision.”<sup>15</sup>

These principles have significance for any company responding to a federal criminal investigation. In the past, because of the Thompson Memo’s now-superseded language, many companies assumed that waiver of the attorney-client privilege was virtually mandatory. Not surprisingly, corporate waivers have become increasingly common in recent years. That assumption no longer applies. This policy change opens a broader range of strategies and tactical choices for companies.

It still may make sense in some cases for a company voluntarily to waive privilege. Indeed, the McNulty Memo provides that “prosecutors may always favorably consider a corporation’s acquiescence to the government’s waiver request in determining whether a corporation has cooperated in the government’s investigation.” Moreover, nothing in the McNulty Memo changes the fundamental principle that companies are liable, in virtually all cases, for criminal misconduct by their employees. Thus, prosecutors will continue to have leverage over companies, and companies will, in turn, continue to have incentives to be cooperative. Over time, however, this tactical retreat by the DOJ may also lead companies in appropriate cases to choose to defend employee conduct more aggressively than in the recent past.

---

<sup>15</sup> The McNulty Memo also adopts a position regarding advancement of legal fees that effectively codifies the June 2006 decision in *U.S. v. Stein*, 435 F. Supp. 2d 330 (S.D.N.Y. June 26, 2006), which held, in a case against former KPMG partners and employees, that the Thompson Memo’s provision on advancing counsel fees, and the actions of the U.S. Attorney’s Office, in implementing those provisions, violated Fifth and Sixth Amendment rights of the defendants. The McNulty Memo states that, in weighing a company’s cooperation, “[p]rosecutors generally should *not* take into account whether a corporation is advancing attorneys’ fees to employees or agents under investigation and indictment.” Companies now are free to advance legal fees to employees in compliance with their charters, by-laws, and policies without fear of being deemed uncooperative.

**Disclosure to Government May Constitute Waiver of Privilege**

A company's voluntary disclosure to government investigators may effect a waiver of both its attorney-client and work-product privileges, notwithstanding the fact that the disclosure of an internal review that had been conducted by outside counsel for its audit committee was made pursuant to agreements with the DOJ and the SEC designed to preserve the confidentiality of the materials being shared. Courts facing this issue have disagreed about the effectiveness of these confidentiality agreements. The court's decision in *In re McKesson HBOC, Inc. Securities Litigation*<sup>16</sup> is illustrative of this uncertainty. The *McKesson* court ruled that, because the company had entered into confidentiality agreements with both the SEC and the U.S. Attorney's Office—pursuant to which it provided the results of an audit committee investigation—the company had not waived attorney work-product protections. The *McKesson* decision, while a welcome development, bluntly disagreed with the reasoning of two other courts<sup>17</sup> that had found that the very same investigate reports were discoverable by plaintiffs, notwithstanding the confidentiality agreements with the government. In another recent decision, *In re Cardinal Health, Inc.*,<sup>18</sup> the court relied on a theory of “common interest” between the company's audit committee and the government in holding that Cardinal Health did not waive attorney work-product protection over information voluntarily disclosed to the SEC and the U.S. Attorney's office, even where no written confidentiality agreement governed the productions to the U.S. Attorney's office. The court held that, because the audit committee's outside counsel prepared the protected information in the course of its internal investigation regarding possible accounting irregularities at the company at the behest of the audit committee, the voluntary disclosure of such information to the government did not constitute a waiver of attorney work-product protection because the audit committee and the government shared a “common interest,” namely, that the company's “financial and accounting practices be ‘clean as a hound's tooth.’”<sup>19</sup>

---

<sup>16</sup> No. C-99-20743 (N.D. Cal. Mar. 31, 2005).

<sup>17</sup> See *McKesson HBOC, Inc. v. Superior Court*, 115 Cal. App. 4th 1229 (2004); *McKesson Corp. v. Green*, 610 S.E.2d 54 (Ga. 2005).

<sup>18</sup> 2007 WL 495150 (S.D.N.Y. Jan. 26, 2007).

<sup>19</sup> 2007 WL 495150 at \*9.

**Caution Recommended**

The best practice is caution. Boards of directors in general, and audit committees in particular, should do their best to establish from the outset of an internal investigation the basis for a valid claim of privilege, weigh very carefully whether a disclosure to the government is appropriate, and, if it is necessary or prudent to report, seek to negotiate the strongest possible confidentiality agreement with the government. At all times, companies must act with an understanding of the fact that there is no certainty that a confidentiality agreement will shield a company from a finding that a disclosure to the government effected a waiver of privilege.



## Audit Committee Member Liability Issues

Understandably, no subject will be of more concern to one asked to serve on an audit committee than that of any potential for personal liability arising from that service. The good news for an audit committee member is that the risk of liability is very slight if he or she acts conscientiously. Neither Sarbanes-Oxley nor any other development has fundamentally affected the fact that an independent audit committee member who performs his or her duties in good faith is highly unlikely to be found liable for losses suffered by reason of such performance. It is true that neither the company nor its legal counsel can issue guarantees; but it is equally true that insulations against personal liability are perfectly adequate today, notwithstanding the fact that they are not, nor can they be expected to be, perfect.

Headlines regarding personal liability of corporate directors, such as those describing the Enron and WorldCom settlements<sup>20</sup> and the Emerging Communications case,<sup>21</sup> have caused increasing anxiety for directors of public companies. Despite the Enron and WorldCom settlements, there is no legal reason for directors to be overly concerned. These two cases are among the most egregious of the series of scandals that followed the bursting of the Millennium Bubble, were the subject of scathing reports by the bankruptcy trustees critical of the directors, involved billions in fraudulent misstatements and were brought under the strict liability provisions of the federal securities laws, not the fiduciary duty requirements of state law. Furthermore, as settlements rather than judicial decisions of liability, they do not have any precedential value for future judicial determinations. It is not necessary for boards to overreact in order to establish entitlement to the protection of the business judgment rule and freedom from the threat of personal liability.

With regard to state law, it is worth remembering that prominent Delaware jurists have repeatedly said that fears of director liability are being exaggerated.

---

<sup>20</sup> The former non-management directors of Enron agreed to pay \$13 million out of their own pockets to settle shareholder lawsuits. The WorldCom settlement of securities fraud litigation relating to public offerings of WorldCom securities called for 12 former directors to pay approximately \$25 million of their own money and insurers to pay \$35 million.

<sup>21</sup> In the 2004 case involving the leveraged buyout of Emerging Communications, the Delaware Chancery Court ruled that a director with particularly relevant expertise could not reasonably rely upon the advice of an outside consultant who opined incorrectly on the fairness of the price to be paid per share.

Former Delaware Supreme Court Justice E. Norman Veasey, for example, has publicly stated that these cases are aberrations. It is his view that the business judgment rule remains a firm protection for directors, and that Delaware, at least, will not impose unrealistic expectations on board members.<sup>22</sup> Vice Chancellor Leo E. Strine likewise has said that “an informed, disinterested business judgment still commands judicial respect in Delaware.”<sup>23</sup> The Delaware Court of Chancery’s decision in the *Disney* case reaffirms this bedrock principle of corporate law.<sup>24</sup>

In *Disney*, shareholders filed suit alleging that the board breached its fiduciary duty of good faith in approving the roughly \$140 million employment and termination package of former *Disney* president Michael Ovitz. While the court ultimately exonerated the board, the court caused a great deal of controversy in the initial stages of the *Disney* case when it denied the directors’ motion to dismiss. According to the court’s initial opinion, if the facts alleged in the complaint were proven at trial, the directors would have been found to have breached their fiduciary duty of good faith in approving Ovitz’s hiring and termination. While some academics and corporate gadflies applauded the court’s initial decision, the business world wondered whether the court’s decision served as a harbinger of potentially massive personal liability for disinterested directorial business decisions—when analyzed under the lens of 20-20 hindsight—even though the directors derived no personal benefit from those decisions. The court’s ultimate decision exonerating the *Disney* directors quiets these concerns.

The *Disney* decision helps delineate the scope of protection of directors against personal liability for claimed breach of fiduciary duty. Negligence—that is, a failure to use due care—should not result in personal liability unless the director failed to act in “good faith.” The court ruled that “intentional dereliction of duty, a conscious disregard for one’s responsibilities” is an appropriate test for determining whether a director has acted in good faith. According to the court, a director fails to act in good faith when the director (1) “intentionally acts with a purpose other than that of advancing the best interests of the corporation,” (2) “acts with intent to violate applicable positive law” or (3) “intentionally fails

---

<sup>22</sup> Hon. E. Norman Veasey, Remarks at the National Association of Corporate Directors/New York (Mar. 9, 2005).

<sup>23</sup> Vice Chancellor Leo E. Strine, Jr., *Big Deals and Independent Directors: Tips for Being a Successful Fiduciary in the Transactional Setting*, Remarks at the Directors’ Education Institute, Duke University (Mar. 17, 2005).

<sup>24</sup> *In re The Walt Disney Co. Derivative Litig.*, No. Civ. A 15452, 907 A.2d 693 (Del. Ch. Aug. 9, 2005), 124.



to act in the face of a known duty to act, demonstrating a conscious disregard for his duties.”<sup>25</sup>

*Disney* also made clear, however, that, although it strongly encourages directors to employ best practices of corporate governance, as those practices are understood at the time a board acts, directors will not be held liable for failure to comply with “the aspirational ideal of best practices.” In other words, directors will have the benefit of the business judgment rule if they act on an informed basis, in good faith and not in their personal self interest, and, in so doing, they will be free from “*post hoc* penalties from a reviewing court using perfect hindsight.” As the court noted, shareholder redress for failures that arise from faithful management “must come from the markets, through the action of shareholders and the free flow of capital, and not from this Court.”

Three considerations should give directors of large companies comfort that fear of personal liability is unwarranted in normal circumstances. First, with respect to the fiduciary duties of a director to the company and its shareholders, *the business judgment rule remains available* as a protection to directors who meet its prerequisites: namely, lack of conflicting interests, good faith and reasonable attentiveness. Second, most state corporation laws contain a provision such as Section 141(e) of the Delaware General Corporation Law, which provides that directors may rely upon the reports of retained experts or corporate officers so long as due care was used in selecting such persons (or, more broadly, that a reasonable director in the circumstances would have relied on such agents).<sup>26</sup> Third, protection from liability concerns arising from derivative litigation comes from statutes. For instance, Section 102(b)(7) of the Delaware General Corporation Law permits companies to adopt charter provisions to waive liability for monetary damages arising from breach of a director’s duty of care. Most states have adopted such a statute, and most public companies have adopted charter amendments incorporating such a waiver into their charter.

While Sarbanes-Oxley signaled toughness by substantially increasing criminal penalties for securities fraud and by creating a criminal offense of knowingly executing, or attempting to execute, a scheme to defraud shareholders of public companies, as well as by prohibiting loans to directors and coercion of

---

<sup>25</sup> *In re The Walt Disney Co. Derivative Litig.*, 2005 WL 1875804, at \*1-2.

<sup>26</sup> In the *Emerging Communications* case, the director with relevant expertise who was found to have unreasonably relied on the advice of an outside consultant was not independent; the court determined that he had acted to further his own business interests at the expense of the shareholders. *In re Emerging Communications, Inc. Shareholders Litig.*, 2004 Del. Ch. LEXIS 70, at \*145–\*146 (May 3, 2004).

auditors (violations of which could result in SEC enforcement actions), it did not otherwise change the elements of civil liability under the securities laws or create new rights of civil actions for which directors may be liable.

When complex legal, governance or accounting issues arise, it will be useful for a director to ask the following simple questions:

- Have I acted with undivided loyalty to the company and its shareholders and have all my personal interests in this matter been fully disclosed?
- Have I exercised due care in examining the issues underlying the proposed action, including receiving advice as to whether the action is in compliance with applicable rules and regulations?
- Will the proposed action and the relevant facts and circumstance be candidly disclosed to all affected parties?

If the answers to those questions are yes, a director should be fully protected in exercising his or her business judgment, and, even if, with the benefit of hindsight, the judgment proves flawed, the director should not be faulted.

In the words of Norman Veasey, former Chief Justice of Delaware:<sup>27</sup>

Although the law of fiduciary duty recognizes the evolving expectations of the standards of conduct of directors and officers, we must keep in mind that the business judgment rule continues unabated to protect directors' decisions made in good faith and to enable them to set strategic goals for prudent risk-taking. What has evolved in this new era is a sharper judicial focus on the *processes* employed by directors, but it is not a regulatory clamp on their business judgment.

### **Liability Protections—Director and Officer Liability Insurance**

While D&O insurance has become more expensive, there is no change in law that limits the availability of this protection. The nature and extent of D&O

---

<sup>27</sup> Former Chief Justice of the Delaware Supreme Court. Remarks Prepared for Delivery to the National Association of Corporate Directors, October 21, 2003, Washington, DC.

coverage is always a matter requiring reference to the particular contract language involved, since these contracts may vary in material ways. In particular, one must consider the policy period (in recent years these policies have become shorter, not infrequently covering only one year); the policy limits (which pertain to all claims during the policy period); the retention (or self-insurance) amount; co-insurance requirements; and policy exclusions.

It is important that directors (and their counsel) have an opportunity to review the particular terms of a D&O insurance policy, including any retentions or exclusions from coverage. Counsel should try to ensure that, in the event that a restatement is required at a future time, such restatement does not give the insurer a right to rescind the coverage. Another risk to directors in D&O insurance arises from a possible bankruptcy filing. Where the company itself is a beneficiary of the D&O insurance policy, a trustee in bankruptcy, as its successor, may have a conflict of interest with directors who are named in a suit. This risk can be managed by having the company purchase a special supplemental policy that covers just officers and directors and not the company.<sup>28</sup>

As a matter of corporate law, rights to indemnification remain as they have been. The important feature for a new audit committee member to understand is that these rights should commit the company to provide indemnification to the full extent permitted by law. Also, a new director should ascertain whether payments made in settlement of a claim are covered.

While Sarbanes-Oxley does not affect indemnification rights, it may have an effect on the related right under the company's charter or bylaws to advancement of expenses prior to judgment in suits brought against the director by reason of his or her office. Sarbanes-Oxley broadly proscribes the extension of credit by a company to its senior officers and directors or the facilitation of the extension of credit, except with respect to the ordinary business of the company. The prohibition on credit may be read to override state law permitting companies to advance expenses of suit to officers or directors sued by reason of their

---

<sup>28</sup> The bankruptcy court case of *National Century Financial Enterprises v. Gulf Insurance Co.* (Bankr. S.D. Ohio Jan. 10, 2005) illustrates the importance of this point. The bankruptcy of NCFE resulted in a contest between directors of NCFE and the company itself for the proceeds of NCFE's primary D&O insurance policy. The court ruled that NCFE's claim would be only partially subordinated to the directors' claims, underscoring the importance for corporate officers and directors of ensuring that they will have adequate separate D&O insurance policy coverage available for which they will not have to compete with their corporation.

office—a right that under state corporation law is among the most prosaic of “loans.”

State law generally requires an undertaking by a defendant to repay the advance in the event that, at the conclusion of the case, the director is not entitled to indemnification for those expenses. In the view of some corporate practitioners, in light of the fact that the advancement only carries a contingent right to repayment—if a board determines that in its view the suit is without merit (and, thus, the company has no expectation of repayment)—an advancement may not qualify as a proscribed loan under federal law.

### **Audit Committee Can Be Its Own Best Protection**

To be sure, prospective audit committee members must understand that more will be required of them—more time and more effort—than may have been demanded in the past. The legal standard for measuring the duties of audit committee members has not changed in theory. The law always has stated that a corporate director must exercise that degree of diligence that a reasonable person would exercise in all of the circumstances. This vague standard, like all negligence standards, looks to some social context to determine how a hypothetical reasonable person would have acted. It seems clear that all aspects of our legal system—from legislatures and regulators to judges and juries—are likely to demand greater attention and involvement (that is to say, greater commitment) from corporate directors in general, but especially from audit committee members, than in the past.

Failure to meet “reasonable person” expectations could in theory result in liability and in reputational injury. Each risk is a serious matter. When reputations earned over a lifetime for probity, diligence and sound judgment are injured, those audit committee members who sustain such injury cannot regard it as minor. Since one cannot prevent suits from being filed, the only protection against some reputational loss is conscientious and effective performance.

The courts understand the importance to corporate America of having candidates who are willing to serve on audit committees and the necessity of providing them with adequate pay, indemnification and insurance. They also understand that directors should not be seen as guarantors of good results or preventors of the malfeasance, misfeasance or nonfeasance of others, but should be entitled to rely in good faith on corporate documents, committees and experts to a significant degree in making their business judgments. Thus, when audit committee members fulfill their duties in good faith, they should not be concerned

that they will be held personally responsible for mistakes or bad faith actions of management or independent auditors.



*Exhibit Index*

<i>Exhibit A</i>	Model Audit Committee Charter for NYSE-listed Company .....	A-1
<i>Exhibit B</i>	Model Audit Committee Charter for NASDAQ-listed Company.....	B-1
<i>Exhibit C</i>	Model Audit Committee Preapproval Policy .....	C-1
<i>Exhibit D</i>	Model Employee Complaint Procedures for Accounting and Auditing Matters.....	D-1
<i>Exhibit E</i>	Model Audit Committee Member Financial Expertise and Independence Questionnaire .....	E-1
<i>Exhibit F</i>	Model Policies and Procedures with respect to Related Person Transactions.....	F-1





## *Exhibit A*

### **AUDIT COMMITTEE CHARTER<sup>1</sup>** (NYSE-listed Company)

#### **Purpose**

The Audit Committee is appointed by the Board to assist the Board in monitoring (1) the integrity of the financial statements of the Company, (2) the independent auditor's qualifications and independence, (3) the performance of the Company's internal audit function and independent auditors, and (4) the compliance by the Company with legal and regulatory requirements.<sup>2</sup>

The Audit Committee shall prepare the report required by the rules of the Securities and Exchange Commission (the "Commission") to be included in the Company's annual proxy statement.<sup>3</sup>

#### **Committee Membership**

The Audit Committee shall consist of no fewer than three members.<sup>4</sup> The members of the Audit Committee shall meet the independence and experience requirements of the New York Stock Exchange (the "NYSE"), Section 10A(m)(3) of the Securities Exchange Act of 1934, as amended (the "Exchange Act") and the rules and regulations of the Commission.<sup>5</sup> At least one member of the Audit

---

<sup>1</sup> An audit committee charter must be adopted by the board pursuant to Section 303A.07(c) of the New York Stock Exchange Listed Company Manual. See also Item 7(d) of Schedule 14A, Item 407(d) and Instruction 2 to Item 407 of Regulation S-K, pursuant to which a company must disclose in its annual proxy statement whether it has adopted a written charter for the audit committee and whether a current copy of the audit committee charter is available on the company's website (and, if so, the company's website address). If a current copy of the audit committee charter is not available on the company's website, a copy of the audit committee charter must be included as an appendix to the proxy statement at least once every three fiscal years or if the charter has been materially amended since the beginning of the last fiscal year. If a current copy of the audit committee charter is not available on the company's website and is not being included in the company's proxy statement, the company must identify in which of the prior fiscal years the audit committee charter was so included.

<sup>2</sup> NYSE Listed Company Manual Section 303A.07(c)(i)(A).

<sup>3</sup> NYSE Listed Company Manual Section 303A.07(c)(i)(B). See Item 407(d) of Regulation S-K and Item 7(d) of Schedule 14A.

<sup>4</sup> NYSE Listed Company Manual Section 303A.07(a).

<sup>5</sup> NYSE Listed Company Manual Sections 303A.07(a) and 303A.07(b) require that each member of an audit committee be (a) "independent" (as defined by the NYSE Listed Company Manual) and (b) "financially literate" (as such qualification is interpreted by the board in its business judgment), or must become financially literate within a reasonable period of time after his or her appointment. In addition, at least one

Committee shall be an “audit committee financial expert” (as defined by the Commission).<sup>6</sup> Audit Committee members shall not simultaneously serve on the audit committees of more than two other public companies.<sup>7</sup>

The members of the Audit Committee shall be appointed by the Board on the recommendation of the Nominating & Governance Committee.<sup>8</sup> Audit Committee members may be replaced by the Board.

### **Meetings**

The Audit Committee shall meet as often as it determines necessary, but not less frequently than quarterly. The Audit Committee shall meet periodically in separate executive sessions with management (including the chief financial officer and chief accounting officer), the internal auditors and the independent auditor, and have such other direct and independent interaction with such persons from time to time as the members of the Audit Committee deem appropriate.<sup>9</sup> The Audit Committee may request any officer or employee of the Company or the Company’s outside counsel or independent auditor to attend a meeting of the

---

member must have accounting or financial management expertise, as the board interprets such qualification in its business judgment. NYSE Listed Company Manual Section 303A.06 provides that all listed companies must have audit committees that satisfy the requirements of Rule 10A-3 under the Exchange Act. Rule 10A-3 (added by Section 301 of Sarbanes-Oxley) requires the NYSE and NASDAQ to prohibit the listing of any company unless each member of the audit committee is “independent,” which is defined to mean that such individual may not, other than in his or her capacity as a member of the audit committee, the board, or any other board committee: (A) accept directly or indirectly any consulting, advisory, or other compensatory fee from the issuer or any subsidiary thereof, *provided* that, unless the rules of the national securities exchange or national securities association provide otherwise, compensatory fees do not include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the listed issuer (*provided* that such compensation is not contingent in any way on continued service); or (B) be an affiliated person of the issuer or any subsidiary thereof.

<sup>6</sup> See Item 407(d)(5) of Regulation S-K. Commentary to NYSE Listed Company Manual Section 303A.07(a) provides that a board may presume that an audit committee member possesses “accounting or financial management expertise” if he or she satisfies the Commission’s definition of an “audit committee financial expert.”

<sup>7</sup> Commentary to NYSE Listed Company Manual Section 303A.07(a) states that if an audit committee member simultaneously serves on the audit committee of more than three public companies, and the NYSE-listed company does not limit the number of audit committees on which its audit committee members serve to three or less, then, in each case, the board must determine that such simultaneous service would not impair the ability of such member to effectively serve on the listed company’s audit committee and disclose such determination in the proxy statement.

<sup>8</sup> NYSE Listed Company Manual Section 303A.04 places responsibility for board committee nominations in the independent nominating & corporate governance committee.

<sup>9</sup> NYSE Listed Company Manual Section 303A.07(c)(iii)(E).

Audit Committee or to meet with any members of, or consultants to, the Committee.

### **Committee Authority and Responsibilities**

The Audit Committee shall have the sole authority to appoint or replace the independent auditor (subject, if applicable, to shareholder ratification).<sup>10</sup> The Audit Committee shall be directly responsible for the compensation and oversight of the work of the independent auditor (including resolution of disagreements between management and the independent auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work.<sup>11</sup> The independent auditor shall report directly to the Audit Committee.<sup>12</sup>

The Audit Committee shall preapprove all auditing services, internal control-related services and permitted non-audit services (including the terms thereof) to be performed for the Company by its independent auditor, subject to the *de minimis* exceptions for non-audit services described in Section 10A(i)(1)(B) of the Exchange Act that are approved by the Audit Committee prior to the completion of the audit.<sup>13</sup> The Audit Committee shall review and discuss with the independent auditor any documentation supplied by the independent auditor as to the nature and scope of any tax services to be approved, as well as the potential effects of the provision of such services on the auditor's independence.<sup>14</sup> The Audit Committee may form and delegate authority to subcommittees consisting of one or more members when appropriate, including the authority to grant preapprovals of audit and permitted non-audit services,

---

<sup>10</sup> NYSE Listed Company Manual Section 303A.06 and Rule 10A-3 under the Exchange Act.

<sup>11</sup> Rule 10A-3(b)(2) under the Exchange Act (added by Section 301 of Sarbanes-Oxley) requires an audit committee of each listed issuer, in its capacity as a committee of the board, to be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm engaged (including resolution of disagreements between management and an independent auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the listed issuer.

<sup>12</sup> Rule 10A-3(b)(2) under the Exchange Act (added by Section 301 of Sarbanes-Oxley) requires each registered public accounting firm to report directly to the audit committee.

<sup>13</sup> Sections 10A(h) and 10A(i) of the Exchange Act (added by Sections 201 and 202 of Sarbanes-Oxley) require such preapproval with respect to services provided by a registered public accounting firms to its audit clients.

<sup>14</sup> This flows from PCAOB Rule 3524, PCAOB Release No. 2005-014 (July 26, 2005).

*provided* that decisions of such subcommittee to grant preapprovals shall be presented to the full Audit Committee at its next scheduled meeting.<sup>15</sup>

The Audit Committee shall have the authority, to the extent it deems necessary or appropriate, to retain independent legal, accounting or other advisors.<sup>16</sup> The Company shall provide appropriate funding, as determined by the Audit Committee, for payment of compensation to the independent auditor for the purpose of rendering or issuing an audit report or performing other audit, review or attest services for the Company and to any advisors employed by the Audit Committee, as well as funding for the payment of ordinary administrative expenses of the Audit Committee that are necessary or appropriate in carrying out its duties.<sup>17</sup>

The Audit Committee shall make regular reports to the Board.<sup>18</sup> The Audit Committee shall annually review the Audit Committee's own performance.<sup>19</sup>

The Audit Committee, to the extent it deems necessary or appropriate, shall:

Financial Statement and Disclosure Matters

1. Meet to review and discuss with management and the independent auditor the annual audited financial statements, including the Company's specific disclosures made in management's discussion and analysis, and recommend to the Board whether the audited financial statements should be included in the Company's Form 10-K.<sup>20</sup>
2. Meet to review and discuss with management and the independent auditor the Company's quarterly financial statements prior to the

---

<sup>15</sup> Section 10A(i)(3) of the Exchange Act (added by Section 202 of Sarbanes-Oxley).

<sup>16</sup> Rule 10A-3(b)(4) under the Exchange Act (adopted by the Commission pursuant to Section 301 of Sarbanes-Oxley).

<sup>17</sup> Section 10A(m)(6) of the Exchange Act (added by Section 301 of Sarbanes-Oxley).

<sup>18</sup> NYSE Listed Company Manual Section 303A.07(c)(iii)(H).

<sup>19</sup> NYSE Listed Company Manual Section 303A.07(c)(ii).

<sup>20</sup> NYSE Listed Company Manual Section 303A.07(c)(iii)(B); Item 407(d) of Regulation S-K.

filing of its Form 10-Q, including the results of the independent auditor's review of the quarterly financial statements.<sup>21</sup>

3. Discuss with management and the independent auditor significant financial reporting issues and judgments made in connection with the preparation of the Company's financial statements, including any significant changes in the Company's selection or application of accounting principles.<sup>22</sup>
4. Review and discuss with management and the independent auditor any major issues as to the adequacy of the Company's internal controls, any special steps adopted in light of material control deficiencies and the adequacy of disclosures about changes in internal control over financial reporting.<sup>23</sup>
5. Review and discuss with management (including the senior internal audit executive) and the independent auditor the Company's internal controls report and the independent auditor's attestation of the report prior to the filing of the Company's Form 10-K.<sup>24</sup>
6. Review and discuss quarterly reports from the independent auditors on:
  - (a) all critical accounting policies and practices to be used;
  - (b) all alternative treatments of financial information within generally accepted accounting principles (GAAP) that have been discussed with management, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the independent auditor;<sup>25</sup> and

---

<sup>21</sup> NYSE Listed Company Manual Section 303A.07(c)(iii)(B).

<sup>22</sup> General commentary to NYSE Listed Company Manual Section 303A.07(c).

<sup>23</sup> General commentary to NYSE Listed Company Manual Section 303A.07(c).

<sup>24</sup> Implicit in the audit committee's responsibility to oversee a company's internal auditing functions is its review with management and the independent auditor of management's internal control report and the independent auditor's attestation of that report pursuant to Item 308 of Regulation S-K. *See* SEC Release No. 33-8238.

<sup>25</sup> General commentary to NYSE Listed Company Manual Section 303A.07(c).

- (c) other material written communications between the independent auditor and management, such as any management letter or schedule of unadjusted differences.<sup>26</sup>
- 7. Discuss with management the Company's earnings press releases, including the use of "*pro forma*" or "adjusted" non-GAAP information, as well as financial information and earnings guidance provided to analysts and rating agencies. Such discussions may be general (consisting of discussing the types of information to be disclosed and the types of presentations to be made), and each earnings release or each instance in which the Company provides earnings guidance need not be discussed in advance.<sup>27</sup>
- 8. Discuss with management and the independent auditor the effect of regulatory and accounting initiatives as well as off-balance sheet structures on the Company's financial statements.<sup>28</sup>
- 9. Discuss with management the Company's major financial risk exposures and the steps management has taken to monitor and control such exposures, including the Company's risk assessment and risk management policies.<sup>29</sup>
- 10. Discuss with the independent auditor the matters required to be discussed by Statement on Auditing Standards No. 61 relating to the conduct of the audit, including any difficulties encountered in the course of the audit work, any restrictions on the scope of activities or access to requested information, and any significant disagreements with management.<sup>30</sup>
- 11. Review disclosures made to the Audit Committee by the Company's CEO and CFO during their certification process for the

---

<sup>26</sup> Section 10A(k) of the Exchange Act (added by Section 204 of Sarbanes-Oxley) requires registered public accounting firms to provide such reports on a timely basis; *see also* commentary to NYSE Listed Company Manual Section 303A.07(c)(iii)(F).

<sup>27</sup> NYSE Listed Company Manual Section 303A.07(c)(iii)(C) and the commentary thereto, and the general commentary to NYSE Listed Company Manual Section 303A.07(c).

<sup>28</sup> General commentary to NYSE Listed Company Manual Section 303A.07(c).

<sup>29</sup> NYSE Listed Company Manual Section 303A.07(c)(iii)(D) and the commentary thereto.

<sup>30</sup> Item 407(d) of Regulation S-K and NYSE Listed Company Manual Section 303A.07(c)(iii)(F).

Form 10-K and Form 10-Q about any significant deficiencies in the design or operation of internal controls or material weaknesses therein and any fraud involving management or other employees who have a significant role in the Company's internal controls.<sup>31</sup>

Oversight of the Company's Relationship with the Independent Auditor

12. Review and evaluate the lead partner of the independent auditor team.<sup>32</sup>
13. Obtain and review a report from the independent auditor at least annually regarding (a) the independent auditor's internal quality-control procedures, (b) any material issues raised by the most recent internal quality-control review, or peer review, of the independent auditor, or by any inquiry or investigation by governmental or professional authorities within the preceding five years respecting one or more independent audits carried out by the independent auditor, (c) any steps taken to deal with any such issues and (d) all relationships between the independent auditor and the Company. Evaluate the qualifications, performance and independence of the independent auditor, including considering whether the independent auditor's quality controls are adequate and the provision of permitted non-audit services is compatible with maintaining the auditor's independence, taking into account the opinions of management and internal auditors. The Audit Committee shall present its conclusions with respect to the independent auditor to the Board.<sup>33</sup>
14. Ensure the rotation of the audit partners as required by law. Consider whether, in order to ensure continuing auditor independence, it is appropriate to adopt a policy of rotating the independent auditing firm on a regular basis.<sup>34</sup>

---

<sup>31</sup> Exchange Act Rule 13a-14 (adopted by the Commission pursuant to Section 302 of Sarbanes-Oxley) requires that the CEO and CFO certify in each 10-K and 10-Q that they have disclosed such information to a company's independent auditors and the audit committee.

<sup>32</sup> Commentary to NYSE Listed Company Manual Section 303A.07(c)(iii)(A).

<sup>33</sup> NYSE Listed Company Manual Section 303A.07(c)(iii)(A) and the commentary thereto.

<sup>34</sup> Commentary to NYSE Listed Company Manual Section 303A.07(c)(iii)(A). Section 10A(j) of the Exchange Act (added by Section 203 of Sarbanes-Oxley) makes it unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner having

15. Set policies for the Company's hiring of employees or former employees of the independent auditor.<sup>35</sup>
16. Discuss with the independent auditor material issues on which the national office of the independent auditor was consulted by the Company's audit team.<sup>36</sup>
17. Meet with the independent auditor prior to the audit to discuss the planning and staffing of the audit.<sup>37</sup>

#### Oversight of the Company's Internal Audit Function

18. Review the appointment and replacement of the senior internal auditing executive.<sup>38</sup>
19. Review the significant reports to management prepared by the internal auditing department and management's responses.<sup>39</sup>
20. Discuss with the independent auditor and management the internal audit department's responsibilities, budget and staffing and any recommended changes in the planned scope of the internal audit.<sup>40</sup>

---

primary responsibility for the audit, or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the five previous fiscal years of that issuer.

<sup>35</sup> NYSE Listed Company Manual Section 303A.07(c)(iii)(G). Section 10A(l) of the Exchange Act (added by Section 206 of Sarbanes-Oxley) makes it unlawful for a registered public accounting firm to perform for an issuer any audit service if a CEO, comptroller, CFO, chief accounting officer or any individual serving in an equivalent position for the issuer was employed by that registered public accounting firm and participated in any capacity in the audit of that issuer during the one-year period preceding the date of initiation of the audit; Commission and PCAOB rules further expand upon the impact the hiring of employees or former employees of the independent auditor may have on the auditor's independence.

<sup>36</sup> Commentary to NYSE Listed Company Manual Section 303A.07(c)(iii)(F).

<sup>37</sup> This is part of an audit committee's responsibility for having sole authority to retain the independent auditor and for approving all audit engagement fees and terms (*see* Rule 10A-3(b)(2) under the Exchange Act).

<sup>38</sup> NYSE Listed Company Manual Section 303A.07(d) requires each listed company to have an internal audit function, although it does not require companies to establish a separate internal audit department. A company may choose to outsource this function to a third-party service provider other than its independent auditor.

<sup>39</sup> This relates to one of an audit committee's principal purposes to assist board oversight of the performance of a company's internal audit function (*see* NYSE Listed Company Manual Section 303A.07(d)).

<sup>40</sup> Commentary to NYSE Listed Company Manual Section 303A.07(c)(iii)(H).



### Compliance Oversight Responsibilities

21. Obtain from the independent auditor assurance that Section 10A(b) of the Exchange Act has not been implicated.<sup>41</sup>
22. Obtain reports from management, the Company's senior internal auditing executive and the independent auditor that the Company and its subsidiary/foreign affiliated entities are in conformity with applicable legal requirements and the Company's Code of Business Conduct and Ethics. Review reports and disclosures of insider and affiliated party transactions. Advise the Board with respect to the Company's policies and procedures regarding compliance with applicable laws and regulations and with the Company's Code of Business Conduct and Ethics.<sup>42</sup>
23. Establish procedures for the receipt, retention and treatment of complaints received by the Company regarding accounting, internal accounting controls or auditing matters, and the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters.<sup>43</sup>
24. Discuss with management and the independent auditor any correspondence with regulators or governmental agencies and any published reports that raise material issues regarding the Company's financial statements or accounting policies.<sup>44</sup>

---

<sup>41</sup> Section 10A(b) of the Exchange Act requires an independent auditor, if it detects or becomes aware of any illegal act, to assure that the audit committee is adequately informed and to provide a report if the independent auditor has reached specified conclusions with respect to such illegal acts.

<sup>42</sup> This relates to one of an audit committee's principal purposes to assist board oversight of the company's compliance with legal and regulatory requirements (*see* commentary to NYSE Listed Company Manual Sections 303A.07(c)(iii)(D) and 303A.07(c)(iii)(H)).

<sup>43</sup> Rule 10A-3(b)(3) under the Exchange Act requires listed company audit committees to establish such procedures.

<sup>44</sup> This relates to one of an audit committee's principal purposes to assist board oversight of the integrity of a company's financial statements (*see* general commentary to NYSE Listed Company Manual Section 303A.07(c)).

25. Discuss with the Company's General Counsel legal matters that may have a material impact on the financial statements or the Company's compliance policies and internal controls.<sup>45</sup>
26. Review and approve or ratify all related-party transactions in accordance with the Company's Policies and Procedures with respect to Related-Person Transactions.<sup>46</sup>

### **Limitation of Audit Committee's Role**

While the Audit Committee has the responsibilities and powers set forth in this Charter, it is not the duty of the Audit Committee to plan or conduct audits or to determine that the Company's financial statements and disclosures are complete and accurate and are in accordance with generally accepted accounting principles applicable rules and regulations. These are the responsibilities of management and the independent auditor.<sup>47</sup>

---

<sup>45</sup> This relates to one of an audit committee's principal purposes to assist board oversight of the company's compliance with legal and regulatory requirements (*see* general commentary to NYSE Listed Company Manual Section 303A.07(c) and commentary to NYSE Listed Company Manual Section 303A.07(c)(iii)(H)).

<sup>46</sup> Commission rules mandate that companies disclose the persons or groups of persons on the board or otherwise who are responsible for applying the company's policies and procedures regarding related-party transactions. Item 404 of Regulation S-K. Section 307 of the NYSE Listed Company Manual recommends that the audit committee or another independent body of the board be responsible for the review and oversight of related-party transactions. The term "related-party transaction" refers to transactions required to be disclosed pursuant to SEC Regulation S-K, Item 404.

<sup>47</sup> General commentary to NYSE Listed Company Manual Section 303A.07(c).

## *Exhibit B*

### **AUDIT COMMITTEE CHARTER<sup>1</sup>** (NASDAQ-listed Company)

#### **Purpose**

The Audit Committee is appointed by the Board to oversee the accounting and financial reporting processes of the Company and the audits of the Company's financial statements.<sup>2</sup> In that regard, the Audit Committee assists the Board in monitoring (1) the integrity of the financial statements of the Company, (2) the independent auditor's qualifications and independence, (3) the performance of the Company's internal audit function<sup>3</sup> and independent auditors, and (4) the compliance by the Company with legal and regulatory requirements.

The Audit Committee shall prepare the report required by the rules of the Securities and Exchange Commission (the "Commission") to be included in the Company's annual proxy statement.<sup>4</sup>

#### **Committee Membership**

The Audit Committee shall consist of no fewer than three members.<sup>5</sup> Each member of the Audit Committee shall meet the independence and experience requirements of The NASDAQ Stock Market, Inc. Marketplace Rules

---

<sup>1</sup> Pursuant to NASDAQ Rule 4350(d)(1), each company must certify that it has adopted a formal written audit committee charter. See also Item 7(d) of Schedule 14A, Item 407(d) and Instruction 2 to Item 407 of Regulation S-K, pursuant to which the company must disclose in its annual proxy statement whether it has adopted a written charter for the audit committee and whether a current copy of the audit committee charter is available on the company's website (and, if so, the company's website address). If a current copy of the audit committee charter is not available on the company's website, a copy of the audit committee charter must be included as an appendix to the proxy statement at least once every three fiscal years, or if the charter has been materially amended since the beginning of the last fiscal year. If a current copy of the audit committee charter is not available on the company's website and is not being included in the company's proxy statement, the company must identify in which of the prior fiscal years the audit committee charter was so included.

<sup>2</sup> NASDAQ Rule 4350(d)(1)(C).

<sup>3</sup> Although NASDAQ does not require its listed companies to have an internal audit function, if an internal audit function exists at the listed company, it is appropriate for an audit committee to monitor its performance.

<sup>4</sup> See Item 407(d) of Regulation S-K and Item 7(d) of Schedule 14A.

<sup>5</sup> NASDAQ Rule 4350(d)(2)(A).

and the Securities Exchange Act of 1934, as amended (the “Exchange Act”).<sup>6</sup> All members of the Audit Committee shall be able to read and understand fundamental financial statements.<sup>7</sup> No member of the Audit Committee shall have participated in the preparation of the financial statements of the Company in the past three years.<sup>8</sup> At least one member of the Audit Committee shall be an “audit committee financial expert” as defined by the Commission.<sup>9</sup> However, one director who does not meet the NASDAQ definition of independence, but who meets the criteria set forth in Section 10A(m)(3) under the Exchange Act and the rules thereunder, and who is not a current officer or employee or a family member of such individual, may serve for no more than two years on the Audit Committee if the Board, under exceptional and limited circumstances, determines that such individual’s membership is required by the best interests of the Company and its shareholders.<sup>10</sup> Such individual must satisfy the independence requirements set forth in Section 10A(m)(3) of the Exchange Act, and may not chair the Audit Committee. The use of this “exceptional and limited circumstances” exception, as well as the nature of the individual’s relationship to the Company and the basis for the Board’s determination, shall be disclosed in the annual proxy statement.<sup>11</sup>

---

<sup>6</sup> NASDAQ Rule 4350(d)(2)(A) requires that each member of an audit committee be “independent” as defined by NASDAQ Rule 4200(a)(15) and not have participated in the preparation of the financial statements of the company or any current subsidiary of the company at any time during the past three years. NASDAQ Rule 4350(d)(2)(A) also provides that audit committee members must satisfy the independence requirements of Exchange Act Rule 10A-3(b) (subject to the exemptions provided in Rule 10A-3(c)). Exchange Act Rule 10A-3(b)(1) requires the NYSE and NASDAQ to prohibit the listing of any company unless each member of the audit committee is “independent,” which is defined to mean that such individual may not, other than in his or her capacity as a member of the audit committee, the board, or any other board committee: (A) accept directly or indirectly any consulting, advisory, or other compensatory fee from the issuer or any subsidiary thereof, provided that, unless the rules of the national securities exchange or national securities association provide otherwise, compensatory fees do not include the receipt of fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the listed issuer (*provided* that such compensation is not contingent in any way on continued service); or (B) be an affiliated person of the issuer or any subsidiary thereof.

<sup>7</sup> NASDAQ Rule 4350(d)(2)(A).

<sup>8</sup> NASDAQ Rule 4350(d)(2)(A)(iii). The Rule explains that “financial statements” includes a company’s balance sheet, income statement and cash flow statement.

<sup>9</sup> See Item 407(d)(5) of Regulation S-K. NASDAQ Rule 4350(d)(2)(A) requires that at least one audit committee member have past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background that results in the individual’s financial sophistication, including being or having been a CEO, CFO or other senior officer with financial oversight responsibilities. NASDAQ Interpretive Material states that this requirement will be deemed to be met by anyone who qualifies as an “audit committee financial expert” within the meaning of the Exchange Act Rules. See IM-4350-4.

<sup>10</sup> NASDAQ Rule 4350(d)(2)(B).

<sup>11</sup> Or, if the issuer does not file a proxy, in its Form 10-K or 20-F.

In addition, if an Audit Committee member ceases to be independent for reasons outside the member's reasonable control, his or her membership on the Audit Committee may continue until the earlier of the Company's next annual shareholders' meeting or one year from the occurrence of the event that caused the failure to qualify as independent.<sup>12</sup> If the Company is not already relying on this provision, and falls out of compliance with the requirements regarding Audit Committee composition due to a single vacancy on the Audit Committee, then the Company will have until the earlier of the next annual shareholders' meeting or one year from the occurrence of the event that caused the failure to comply with this requirement.<sup>13</sup> The Company shall provide notice to NASDAQ immediately upon learning of the event or circumstance that caused the noncompliance, if it expects to rely on either of these provisions for a cure period.

The members of the Audit Committee shall be appointed and may be replaced by the Board.

### **Meetings**

The Audit Committee shall meet as often as it determines necessary, but not less frequently than quarterly. The Audit Committee shall meet periodically in separate executive sessions with management, the internal auditors and the independent auditor, and have such other direct and independent interaction with such persons from time to time as the members of the Audit Committee deem appropriate. The Audit Committee may request any officer or employee of the Company or the Company's outside counsel or independent auditor to attend a meeting of the Audit Committee or to meet with any members of, or consultants to, the Committee.

### **Committee Authority and Responsibilities<sup>14</sup>**

The Audit Committee shall have the sole authority to appoint, determine funding for, and oversee the outside auditors (subject, if applicable, to shareholder

---

<sup>12</sup> NASDAQ Rule 4350(d)(4)(A) provides this cure period for the independence requirement.

<sup>13</sup> NASDAQ Rule 4350(d)(4)(B) provides this additional cure period.

<sup>14</sup> NASDAQ Rule 4350(d)(3) provides that an audit committee must have the specific responsibilities and authority necessary to comply with Rule 10A-3(b)(2), (3), (4), and (5) under the Exchange Act (subject to the exemptions provided in Rule 10A-3(c)) concerning responsibilities relating to: (a) registered public accounting firms, (b) complaints relating to accounting, internal accounting controls or auditing matters, (c) authority to engage advisors, and (d) funding as determined by the audit committee.

ratification).<sup>15</sup> The Audit Committee shall be directly responsible for the compensation and oversight of the work of the independent auditor (including resolution of disagreements between management and the independent auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work. The independent auditor shall report directly to the Audit Committee.<sup>16</sup>

The Audit Committee shall preapprove all auditing services, internal control-related services and permitted non-audit services (including the fees and terms thereof) to be performed for the Company by the independent auditor, subject to the *de minimis* exception for non-audit services described in Section 10A(i)(1)(B) of the Exchange Act that are approved by the Audit Committee prior to the completion of the audit.<sup>17</sup> The Audit Committee shall review and discuss with the independent auditor any documentation supplied by the independent auditor as to the nature and scope of any tax services to be approved, as well as the potential effects of the provision of such services on the auditor's independence.<sup>18</sup> The Audit Committee may form and delegate authority to subcommittees consisting of one or more members when appropriate, including the authority to grant preapprovals of audit and permitted non-audit services, *provided* that decisions of such subcommittee to grant preapprovals shall be presented to the full Audit Committee at its next scheduled meeting.<sup>19</sup>

The Audit Committee shall have the authority, to the extent it deems necessary or appropriate, to engage and determine funding for independent legal, accounting or other advisors.<sup>20</sup> The Company shall provide appropriate funding, as determined by the Audit Committee, for payment of compensation to the independent auditor for the purpose of rendering or issuing an audit report or performing other audit, review or attest services for the Company and to any

---

<sup>15</sup> Rule 10A-3(b)(2) under the Exchange Act requires the audit committee of each listed issuer to be directly responsible for the appointment, compensation, retention and oversight of the work of any registered public accounting firm engaged (including resolution of disagreements between management and the independent auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the listed issuer.

<sup>16</sup> Exchange Act Rule 10A-3(b)(2).

<sup>17</sup> Sections 10A(h) and 10A(i) of the Exchange Act (added by Sections 201 and 202 of Sarbanes-Oxley) require such preapproval with respect to services provided by the registered public accounting firms to its audit clients.

<sup>18</sup> This flows from PCAOB Rule 3524, PCAOB Release No. 2005-014 (July 26, 2005).

<sup>19</sup> Section 10A(i)(3) of the Exchange Act (added by Section 202 of Sarbanes-Oxley).

<sup>20</sup> Rule 10A-3(b)(4) under the Exchange Act (adopted by the Commission pursuant to Section 301 of Sarbanes-Oxley).

advisors employed by the Audit Committee, as well as funding for the payment of ordinary administrative expenses of the Audit Committee that are necessary or appropriate in carrying out its duties.<sup>21</sup>

The Audit Committee shall make regular reports to the Board. The Audit Committee shall review and reassess the adequacy of this Charter annually and recommend any proposed changes to the Board for approval.<sup>22</sup>

The Audit Committee, to the extent it deems necessary or appropriate, shall:

Financial Statement and Disclosure Matters

1. Review and discuss with management and the independent auditor the annual audited financial statements, including disclosures made in management's discussion and analysis, and recommend to the Board whether the audited financial statements should be included in the Company's Form 10-K.<sup>23</sup>
2. Review and discuss with management and the independent auditor the Company's quarterly financial statements prior to the filing of its Form 10-Q, including the results of the independent auditor's review of the quarterly financial statements.<sup>24</sup>
3. Discuss with management and the independent auditor significant financial reporting issues and judgments made in connection with the preparation of the Company's financial statements, including any significant changes in the Company's selection or application of accounting principles, any major issues as to the adequacy of the

---

<sup>21</sup> Exchange Act Rule 10A-3(b)(5).

<sup>22</sup> NASDAQ Rule 4350(d)(1). The company must certify that an audit committee has reviewed and reassessed the adequacy of the charter on an annual basis.

<sup>23</sup> Under NASDAQ Rule 4350(d)(1)(C), an audit committee must oversee the accounting and financial reporting processes of the company and the audits of the company's financial statements. See also Item 407(d) of Regulation S-K.

<sup>24</sup> This flows from NASDAQ's requirement that an audit committee oversee the audits of a company's financial statements. NASDAQ Rule 4350(d)(1)(C).

Company's internal controls and any special steps adopted in light of material control deficiencies.<sup>25</sup>

4. Review and discuss with management and the independent auditor any major issues as to the adequacy of the Company's internal controls, any special steps adopted in light of material control deficiencies and the adequacy of disclosures about changes in internal control over financial reporting.<sup>26</sup>
5. Review and discuss with management (including the senior internal audit executive) and the independent auditor the Company's internal controls report and the independent auditor's attestation report prior to the filing of the Company's Form 10-K.<sup>27</sup>
6. Review and discuss quarterly reports from the independent auditors on:
  - (a) all critical accounting policies and practices to be used;
  - (b) all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the independent auditor;<sup>28</sup> and
  - (c) other material written communications between the independent auditor and management, such as any management letter or schedule of unadjusted differences.<sup>29</sup>

---

<sup>25</sup> This responsibility flows from NASDAQ's requirement that an audit committee oversee the accounting and financial reporting processes of a company.

<sup>26</sup> See Paragraphs 78-84 of Appendix A and paragraph C15 of Appendix C to PCAOB Release No. 2007-005A.

<sup>27</sup> Implicit in an audit committee's responsibility to oversee a company's internal auditing functions is its review with management and the independent auditor of management's internal control report and the independent auditor's attestation report pursuant to Item 308 of Regulation S-K.

<sup>28</sup> Rule 10A-3(b)(2) under the Exchange Act requires that an audit committee assume direct responsibility for the appointment, compensation, retention, termination and oversight of an independent auditor, *including* the resolution of disputes between management and the independent auditor regarding financial reporting.

<sup>29</sup> Section 10A(k) of the Exchange Act (added by Section 204 of Sarbanes-Oxley) requires registered public accounting firms to provide such reports on a timely basis.



7. Discuss with management the Company's earnings press releases, including the use of "*pro forma*" or "adjusted" non-GAAP information, as well as financial information and earnings guidance provided to analysts and rating agencies. Such discussion may be done generally (consisting of discussing the types of information to be disclosed and the types of presentations to be made).
8. Discuss with management and the independent auditor the effect of regulatory and accounting initiatives as well as off-balance sheet structures on the Company's financial statements.<sup>30</sup>
9. Discuss with management the Company's major financial risk exposures and the steps management has taken to monitor and control such exposures, including the Company's risk assessment and risk management policies.
10. Discuss with the independent auditor the matters required to be discussed by Statement on Auditing Standards No. 61 relating to the conduct of the audit, including any difficulties encountered in the course of the audit work, any restrictions on the scope of activities or access to requested information, and any significant disagreements with management.<sup>31</sup>
11. Review disclosures made to the Audit Committee by the Company's CEO and CFO during their certification process for the Form 10-K and Form 10-Q about any significant deficiencies in the design or operation of internal controls or material weaknesses therein, and any fraud involving management or other employees who have a significant role in the Company's internal controls.<sup>32</sup>

---

<sup>30</sup> This flows from an audit committee's duty to oversee the accounting and financial reporting processes of a company and the audits of a company's financial statements (NASDAQ Rule 4350(d)(1)(C)).

<sup>31</sup> Item 407(d) of Regulation S-K.

<sup>32</sup> Exchange Act Rule 13a-14 (adopted by the Commission pursuant to Section 302 of Sarbanes-Oxley) requires that the CEO and CFO certify in each 10-K and 10-Q that they have disclosed such information to the company's independent auditors and the audit committee.

12. Ensure that a public announcement of the Company's receipt of an audit opinion that contains a going concern qualification is made promptly.<sup>33</sup>

Oversight of the Company's Relationship with the Independent Auditor

13. Review and evaluate the lead partner of the independent auditor team.<sup>34</sup>
14. Obtain and review a report from the independent auditor at least annually regarding (a) the independent auditor's internal quality-control procedures, (b) any material issues raised by the most recent internal quality-control review, or peer review, of the independent auditor, or by any inquiry or investigation by governmental or professional authorities within the preceding five years respecting one or more independent audits carried out by the independent auditor and (c) any steps taken to deal with any such issues. Evaluate the qualifications, performance and independence of the independent auditor, including considering whether the independent auditor's quality controls are adequate and the provision of permitted non-audit services is compatible with maintaining the auditor's independence, and taking into account the opinions of management and internal auditors. The Audit Committee shall present its conclusions with respect to the independent auditor to the Board.<sup>35</sup>
15. Obtain from the independent auditor a formal written statement delineating all relationships between the independent auditor and the Company. It is the responsibility of the Audit Committee to actively engage in a dialogue with the independent auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the independent auditor and

---

<sup>33</sup> NASDAQ Rule 4350(b)(1)(B) provides that an issuer that receives an audit opinion containing a going concern qualification must make a public announcement through the news media disclosing the receipt of such qualification (and prior to such public announcement, provide notice to NASDAQ's Market Watch Department). The public announcement must be made no later than seven calendar days following the filing of such an audit opinion with the Commission.

<sup>34</sup> This flows from the audit committee's responsibility to oversee the external audit process under NASDAQ Rule 4350(d)(1)(C).

<sup>35</sup> This flows from an audit committee's responsibility to oversee the external audit process under NASDAQ Rule 4350(d)(1)(C).

for purposes of taking, or recommending that the full Board take, appropriate action to oversee the independence of the outside auditor.<sup>36</sup>

16. Ensure the rotation of the lead (or coordinating) audit partner having primary responsibility for the audit and the audit partner responsible for reviewing the audit as required by law. Consider whether, in order to assure continuing auditor independence, it is appropriate to adopt a policy of rotating the independent auditor on a regular basis.<sup>37</sup>
17. Recommend to the Board policies for the Company's hiring of employees or former employees of the independent auditor.<sup>38</sup>
18. Meet with the independent auditor prior to the audit to discuss the planning and staffing of the audit.<sup>39</sup>

#### Oversight of the Company's Internal Audit Function

19. Review the appointment and replacement of the senior internal auditing executive.<sup>40</sup>
20. Review the significant reports to management prepared by the internal auditing department and management's responses.<sup>41</sup>

---

<sup>36</sup> NASDAQ Rule 4350(d)(1)(B); Item 407 (d) of Regulation S-K.

<sup>37</sup> Under NASDAQ Rule 4350(d)(3) and Exchange Act Rule 10A-3(b)(2), an audit committee must have sole authority for appointment, compensation and oversight of the independent auditor. Section 10A(j) of the Exchange Act (added by Section 203 of Sarbanes-Oxley) makes it unlawful for a registered public accounting firm to provide audit services to an issuer if the lead (or coordinating) audit partner having primary responsibility for the audit, or the audit partner responsible for reviewing the audit, has performed audit services for that issuer in each of the five previous fiscal years of that issuer.

<sup>38</sup> Section 10A(l) of the Exchange Act (added by Section 206 of Sarbanes-Oxley) makes it unlawful for a registered public accounting firm to perform for an issuer any audit service if a CEO, comptroller, CFO, chief accounting officer or any individual serving in an equivalent position for the issuer was employed by that registered public accounting firm and participated in any capacity in the audit of that issuer during the one-year period preceding the date of initiation of the audit. Commission and PCAOB rules further expand upon the impact the hiring of employees or former employees of the independent auditor may have on the auditor's independence.

<sup>39</sup> This is part of an audit committee's responsibility for having sole authority to retain the independent auditor and for approving all audit engagement fees and terms (see Rule 10A-3(b)(2) under the Exchange Act).

<sup>40</sup> This flows from an audit committee's obligation to oversee the external audit of a company.

21. Discuss with the independent auditor and management the internal audit department responsibilities, budget and staffing, and any recommended changes in the planned scope of the internal audit.<sup>42</sup>

Compliance Oversight Responsibilities

22. Obtain from the independent auditor assurance that Section 10A(b) of the Exchange Act has not been implicated.<sup>43</sup>
23. Obtain reports from management, the Company's senior internal auditing executive and the independent auditor that the Company and its subsidiary/foreign affiliated entities are in conformity with applicable legal requirements and the Company's Code of Business Conduct and Ethics. Advise the Board with respect to the Company's policies and procedures regarding compliance with applicable laws and regulations and with the Company's Code of Business Conduct and Ethics.
24. Review and oversee all related-party transactions in accordance with the Company's Policies and Procedures with respect to Related-Person Transactions.<sup>44</sup>
25. Establish procedures for the receipt, retention and treatment of complaints received by the Company regarding accounting, internal accounting controls or auditing matters, and the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters.<sup>45</sup>

---

<sup>41</sup> This relates to one of an audit committee's principal purposes: to assist board oversight of the performance of a company's internal audit function.

<sup>42</sup> This flows from an audit committee's obligation to oversee the external audit of a company.

<sup>43</sup> Section 10A(b) of the Exchange Act requires the independent auditor, if it detects or becomes aware of any illegal act, to assure that the audit committee is adequately informed and to provide a report if the independent auditor has reached specified conclusions with respect to such illegal acts.

<sup>44</sup> Commission rules mandate that companies disclose the persons or groups of persons on the board or otherwise who are responsible for applying the company's policies and procedures regarding related-party transactions. Item 404 of Regulation S-K. NASDAQ Rule 4350(h) provides that each listed issuer shall conduct appropriate review and oversight of all related-party transactions for potential conflict of interest situations on an ongoing basis by a company's audit committee or another independent body of the board. The term "related-party transaction" refers to transactions required to be disclosed pursuant to Commission Regulation S-K, Item 404.

<sup>45</sup> NASDAQ Rule 4350(d)(3) and Rule 10A-3(b)(3) under the Exchange Act.

26. Discuss with management and the independent auditor any correspondence with regulators or governmental agencies and any published reports that raise material issues regarding the Company's financial statements or accounting policies.<sup>46</sup>
27. Discuss with the Company's General Counsel legal matters that may have a material impact on the financial statements or the Company's compliance policies.<sup>47</sup>

### **Limitation of Audit Committee's Role**

While the Audit Committee has the responsibilities and powers set forth in this Charter, it is not the duty of the Audit Committee to plan or conduct audits or to determine that the Company's financial statements and disclosures are complete and accurate and are in accordance with generally accepted accounting principles and applicable rules and regulations. These are the responsibilities of management and the independent auditor.

---

<sup>46</sup> This relates to one of an audit committee's principal purposes: to assist board oversight of the integrity of a company's financial statements (NASDAQ Rule 4350(d)(1)(C)).

<sup>47</sup> This relates to one of an audit committee's principal purposes: to assist board oversight of a company's compliance with legal and regulatory requirements.



## *Exhibit C*

### **MODEL AUDIT COMMITTEE PREAPPROVAL POLICY**

#### **I. STATEMENT OF PRINCIPLES**

The Audit Committee must pre-approve the audit and non-audit services performed by the independent auditor in order to ensure that the provision of such services does not impair the auditor's independence. Before the Company or any of its subsidiaries engages the independent auditor to render a service, the engagement must be either:

- (1) specifically approved by the Audit Committee; or
- (2) entered into pursuant to this Preapproval Policy.

The Audit Committee shall review and discuss with the independent auditor any documentation supplied by the independent auditor as to the nature and scope of any tax services to be approved, as well as the potential effects of the provision of such services on the auditor's independence.<sup>1</sup>

The appendices to this Preapproval Policy describe in detail the particular audit, audit-related, tax and other services that have the preapproval of the Audit Committee pursuant to this Preapproval Policy.<sup>2</sup> The term of any preapproval is 12 months from the date of preapproval, unless the Audit Committee specifically provides for a different period. The Audit Committee shall periodically revise the list of pre-approved services.

#### **II. DELEGATION**

The Audit Committee may delegate preapproval authority to one or more of its members. The member or members to whom such authority is delegated shall report any preapproval decisions to the Audit Committee at its next scheduled meeting. The Audit Committee may not delegate to management the

---

<sup>1</sup> This flows from PCAOB Rule 3524, PCAOB Release No. 2005-014 (July 26, 2005).

<sup>2</sup> The services listed in the appendices are for illustrative purposes only.

Audit Committee's responsibilities to preapprove services performed by the independent auditor.

### III. AUDIT SERVICES

The Audit Committee must specifically preapprove the terms of the annual audit services engagement. The Audit Committee shall approve, if necessary, any changes in terms resulting from changes in audit scope, Company structure or other matters.

In addition to the annual audit services engagement approved by the Audit Committee, the Audit Committee may grant preapproval for other audit services, which are those services that only the independent auditor reasonably can provide. The Audit Committee has pre-approved the audit services listed in Appendix A. All other audit services not listed in Appendix A must be specifically preapproved by the Audit Committee.

### IV. AUDIT-RELATED SERVICES

Audit-related services, including internal control-related services, are assurance and related services that are reasonably related to the performance of the audit or review of the Company's financial statements and/or the Company's internal control over financial reporting and that are traditionally performed by the independent auditor. The Audit Committee believes that the provision of audit-related services does not impair the independence of the auditor, and has pre-approved the audit-related services listed in Appendix B. All other audit-related services not listed in Appendix B must be specifically pre-approved by the Audit Committee.

### V. TAX SERVICES

The Audit Committee believes that the independent auditor can provide tax services to the Company, such as tax compliance, tax planning and tax advice, without impairing the auditor's independence. However, the Audit Committee shall scrutinize carefully the retention of the independent auditor in connection with any tax-related transaction initially recommended by the independent auditor. The Audit Committee has preapproved the tax services listed in Appendix C. All tax services not listed in Appendix C must be specifically preapproved by the Audit Committee.



## VI. OTHER SERVICES

The Audit Committee may grant preapproval to those permissible non-audit services classified as other services that it believes would not impair the independence of the auditor, including those that are routine and recurring services. The Audit Committee has pre-approved the other services listed in Appendix D. Permissible other services not listed in Appendix D must be specifically pre-approved by the Audit Committee.

A list of the SEC's (Securities and Exchange Commission) prohibited non-audit services is attached to this Preapproval Policy as Exhibit 1. The rules of the SEC and the Public Company Accounting Oversight Board (PCAOB) and relevant guidance should be consulted to determine the precise definitions of these services and the applicability of exceptions to certain of the prohibitions.

## VII. PREAPPROVAL FEE LEVELS

The Audit Committee may consider the amount or range of estimated fees as a factor in determining whether a proposed service would impair the auditor's independence. Where the Audit Committee has approved an estimated fee for a service, the preapproval applies to all services described in the approval. However, in the event the invoice in respect of any such service is materially in excess of the estimated amount or range, the Audit Committee must approve such excess amount prior to payment of the invoice. The Audit Committee expects that any requests to pay invoices in excess of the estimated amounts will include an explanation as to the reason for the overage.<sup>3</sup> The Company's independent auditor will be informed of this policy.

## VIII. SUPPORTING DOCUMENTATION

With respect to each proposed pre-approved service, the independent auditor must provide the Audit Committee with detailed back-up documentation regarding the specific services to be provided.

---

<sup>3</sup> It is understood that estimated amounts that are denominated in dollars but are ordinarily paid in another currency are subject to foreign exchange rate fluctuations. Thus, variances from estimated amounts arising as a result of changes in foreign currency exchange rates from the time of preparation of the relevant approval request will not be considered to be variances from the budgeted amount and payment of the related invoices will not require a subsequent approval.

IX. PROCEDURES

The Company's management shall inform the Audit Committee of each service performed by the independent auditor pursuant to this Preapproval Policy.

Requests or applications to provide services that require separate approval by the Audit Committee shall be submitted to the Audit Committee by both the independent auditor and the [CFO, Treasurer or Controller<sup>4</sup>], and must include a joint statement as to whether, in their view, the request or application is consistent with the SEC's and the PCAOB's rules on auditor independence.

---

<sup>4</sup> Or other designated officer.

**Appendix A**

**Pre-Approved Audit Services for Fiscal Year 2008<sup>5</sup>**

Dated: \_\_\_\_\_, 2008

<b><u>Service</u></b>	<b><u>Estimated Range of Fees</u></b>
Statutory audits or financial audits for subsidiaries or affiliates of the Company	
Services associated with SEC registration statements, periodic reports and other documents filed with the SEC or other documents issued in connection with securities offerings (e.g., comfort letters, consents), and assistance in responding to SEC comment letters	
Consultations by the Company's management as to the accounting or disclosure treatment of transactions or events and/or the actual or potential impact of final or proposed rules, standards or interpretations by the SEC, PCAOB, FASB, or other regulatory or standard-setting bodies (Note: Under SEC rules, some consultations may be "audit-related" services rather than "audit" services)	

<sup>5</sup> The services listed in these appendices are for illustrative purposes only and may not be applicable to a particular company.

**Appendix B**

**Pre-Approved Audit-Related Services for Fiscal Year 2008**

Dated: \_\_\_\_\_, 2008

<u>Service</u>	<u>Estimated Range of Fees</u>
Due diligence services pertaining to potential business acquisitions/dispositions	
Financial statement audits of employee benefit plans	
Agreed-upon or expanded audit procedures related to accounting and/or billing records required to respond to or comply with financial, accounting or regulatory reporting matters	
Consultations by the Company's management as to the accounting or disclosure treatment of transactions or events and/or the actual or potential impact of final or proposed rules, standards or interpretations by the SEC, PCAOB, FASB, or other regulatory or standard-setting bodies (Note: Under SEC rules, some consultations may be "audit" services rather than "audit-related" services)	
Attest services not required by statute or regulation	

**Appendix C**

**Pre-Approved Tax Services for Fiscal Year 2008**

Dated: \_\_\_\_\_, 2008

<b><u>Service</u></b>	<b><u>Estimated Range of Fees</u></b>
U.S. federal, state and local tax planning and advice	
U.S. federal, state and local tax compliance	
International tax planning and advice	
International tax compliance	
Review of U.S. federal, state and local and international income, franchise and other tax returns	
Licensing [ <b>or purchase</b> ] of income tax preparation software <sup>6</sup> from the independent auditor, <i>provided</i> that the functionality is limited to preparation of tax returns	

---

<sup>6</sup> Licensing or purchasing income tax preparation software is permitted so long as the functionality is limited to preparation of tax returns. If the software performs additional functions, each function must be evaluated *separately* for its potential effect on the auditor's independence.

**Appendix D**

**Pre-Approved Other Services for Fiscal Year 2008**

Dated: \_\_\_\_\_, 2008

<u>Service</u>	<b>Estimated Range of Fees</b>

**Exhibit 1**

**Prohibited Non-Audit Services**

- Bookkeeping or other services related to the accounting records or financial statements of the Company<sup>\*</sup>
- Financial information systems design and implementation<sup>\*</sup>
- Appraisal or valuation services, fairness opinions or contribution-in-kind reports<sup>\*</sup>
- Actuarial services<sup>\*</sup>
- Internal audit outsourcing services<sup>\*</sup>
- Management functions
- Human resources
- Broker-dealer, investment adviser or investment banking services
- Legal services
- Expert services unrelated to the audit
- Any services entailing a contingent fee or commission (not including fees awarded by a bankruptcy court when the audit client is in bankruptcy)<sup>†</sup>
- Tax services to an officer of the audit client whose role is in a financial reporting oversight capacity (regardless of whether the audit client or the officer pays the fee for the services)<sup>†</sup>
- Planning or opining on the tax consequences of a “listed,” *i.e.*, tax avoidance, transaction<sup>†</sup>

---

<sup>\*</sup> Provision of these non-audit services is permitted if it is reasonable to conclude that the results of these services will not be subject to audit procedures. Materiality is not an appropriate basis upon which to overcome the rebuttable presumption that prohibited services will be subject to audit procedures because determining materiality is itself a matter of audit judgment.

<sup>†</sup> The prohibitions on tax shelter advice, aggressive tax planning advice and tax services for certain corporate officers flow from the PCAOB’s adoption of certain auditor independence and ethics rules in July 2005. See PCAOB Release No. 2005-014 (July 26, 2005).

- Planning or opining on the tax consequences of a “confidential” transaction, *i.e.*, where tax advice is given under restriction of confidentiality (regardless of the fee to be paid)<sup>†</sup>
- Planning or opining on a transaction that is based on an “aggressive interpretation” of tax laws and regulations, if the transaction was recommended by the audit firm and a significant purpose of which is tax avoidance unless the proposed tax treatment is at least more likely than not to be allowed under current tax laws<sup>†</sup>

---

<sup>†</sup> The prohibitions on tax shelter advice, aggressive tax planning advice and tax services for certain corporate officers flow from the PCAOB’s adoption of certain auditor independence and ethics rules in July 2005. See PCAOB Release No. 2005-014 (July 26, 2005).



## *Exhibit D*

### **MODEL EMPLOYEE COMPLAINT PROCEDURES FOR ACCOUNTING AND AUDITING MATTERS**

Any employee of the Company may submit a good faith complaint regarding accounting or auditing matters to the management of the Company without fear of dismissal or retaliation of any kind. The Company is committed to achieving compliance with all applicable securities laws and regulations, accounting standards, accounting controls and audit practices. The Company's Audit Committee will oversee treatment of employee concerns in this area.

In order to facilitate the reporting of employee complaints, the Company's Audit Committee has established the following procedures for (1) the receipt, retention and treatment of complaints regarding accounting, internal accounting controls or auditing matters ("Accounting Matters") and (2) the confidential, anonymous submission by employees of concerns regarding questionable accounting or auditing matters.

#### Receipt of Employee Complaints

- Employees with concerns regarding Accounting Matters may report their concerns to the General Counsel of the Company.
- Employees may forward complaints on a confidential or anonymous basis to the General Counsel of the Company through a hotline, e-mail or regular mail:

#### **[CONTACT INFORMATION]**

#### Scope of Matters Covered by These Procedures

These procedures relate to employee complaints relating to any questionable accounting or auditing matters, including, without limitation, the following:

- fraud or deliberate error in the preparation, evaluation, review or audit of any financial statement of the Company;
- fraud or deliberate error in the recording and maintaining of financial records of the Company;

## D-2 WLR&K Audit Committee Guide & Best Practices

---

- deficiencies in or noncompliance with the Company's internal accounting controls;
- misrepresentation or false statement to or by a senior officer or accountant regarding a matter contained in the financial records, financial reports or audit reports of the Company; or
- deviation from full and fair reporting of the Company's financial condition.

### Treatment of Complaints

- Upon receipt of a complaint, the General Counsel of the Company will (1) determine whether the complaint actually pertains to Accounting Matters and (2) when possible, acknowledge receipt of the complaint to the sender.
- Complaints relating to Accounting Matters will be reviewed under Audit Committee direction and oversight by the General Counsel of the Company, internal audit or such other persons as the Audit Committee determines to be appropriate. Confidentiality will be maintained to the fullest extent possible, consistent with the need to conduct an adequate review.
- Prompt and appropriate corrective action will be taken when and as warranted in the judgment of the Audit Committee.
- The Company will not discharge, demote, suspend, threaten, harass or in any manner discriminate against any employee in the terms and conditions of employment based upon any lawful actions of such employee with respect to good faith reporting of complaints regarding Accounting Matters or otherwise as specified in Section 806 of the Sarbanes-Oxley Act of 2002.

### Reporting and Retention of Complaints and Investigations

- The General Counsel of the Company will maintain a log of all complaints, tracking their receipt, investigation and resolution and shall prepare a periodic summary report thereof for the Audit Committee. Copies of complaints and such log will be maintained in accordance with the Company's document retention policy.

*Exhibit E*

**MODEL AUDIT COMMITTEE MEMBER  
FINANCIAL EXPERTISE AND INDEPENDENCE QUESTIONNAIRE**

The following questionnaire seeks information necessary to prepare the Company's annual report and proxy statement. The annual report and proxy statement will be filed with the Securities and Exchange Commission and made available to the public. Specifically, the information provided will be used to assist the Board of Directors of the Company in determining your level of financial expertise/literacy and independence within the meaning of the federal securities laws and the major securities markets listing standards for purposes of eligibility for service on the Audit Committee of the Board of Directors. **It is extremely important that your answers be complete and accurate. Accordingly, great care should be exercised in the completion of this questionnaire and the verification of any information about you that is provided herein.**

Please read the Instructions on Page E-3 before completing this questionnaire. Although the questionnaire is designed to be as direct as possible, certain questions, of necessity, require the use of technical terms. It is important that you understand the meaning of these terms before completing the questions. Definitions of such terms are provided in the Explanatory Note/Definitions on Page E-18. Please read the definitions before answering any question that includes one of these defined terms.

Please return your completed questionnaire to **[Name]** at the address below by **[Date]**. If you have questions regarding this questionnaire, please call **[Name]** at **[Number]**, **[Name]** at **[Number]** or **[Name]** at **[Number]**.

**[Name]**  
**[Title]**  
**[Address]**

---

**TABLE OF CONTENTS**

	<u>Page</u>
Instructions	E-3
Questionnaire	E-4
Explanatory Note/Definitions	E-18
Attestation	E-19

### **INSTRUCTIONS**

1. Answer All Questions. Please answer fully and completely all questions that apply to you.
2. Date of Response. Your responses should be accurate as of [**Date**]. If you are unable to respond as of such date, please note why you are unable to do so and clearly indicate the date of the information included in your response.
3. Insufficient Space to Respond. If there is insufficient space to respond to any question in this questionnaire, please attach additional sheets of paper to this questionnaire as necessary.
4. Question Not Applicable. If the answer to any question is “No” or “Not Applicable,” please so state. Should you fail to provide any answer, it will be assumed such answer is negative.
5. Defined Terms. Bolded and capitalized terms are defined in the Explanatory Note/Definitions (Page E-18).

## QUESTIONNAIRE

### 1. Financial Expertise/Literacy

- a. Do you have an understanding of generally accepted accounting principles (“GAAP”) and financial statements?

Yes  No

If your answer to Question 1.a is yes, please explain how you acquired the above understanding (include relevant positions, organizations, dates and job duties):

- b. Do you have the ability to assess the general application of GAAP in connection with the accounting for estimates, accruals and reserves?<sup>1</sup>

Yes  No

If your answer to Question 1.b is yes, please explain how you acquired the above capability (include relevant positions, organizations, dates and job duties):

---

<sup>1</sup> In considering Question 1.b, please note that estimates, accruals and reserves need not be generally comparable to the estimates, accruals and reserves used in the company’s financial statements (*i.e.*, need not be in the same industry). It is the ability to assess, not experience applying, the accounting principles that is the focus of the question.

*Model Audit Committee Member Financial Expertise  
and Independence Questionnaire E-5*

---

- c. Do you have experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that generally are comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the Company's financial statements, or experience **actively supervising** one or more persons engaged in such activities?<sup>2</sup>

Yes  No

If your answer to Question 1.c is yes, please explain how you acquired the above experience (include relevant positions, organizations, dates and job duties):

- d. Do you have an understanding of internal controls and procedures for financial reporting?

Yes  No

If your answer to Question 1.d is yes, please explain how you acquired the above understanding (include relevant positions, organizations, dates and job duties):

---

<sup>2</sup> In considering Question 1.c, please note that the relevant experience can include working directly and closely with financial statements in a way that provides familiarity with their contents and the processes behind them. Experience also includes active engagement in industries the same as those engaged in by the company and significant direct and close exposure to, and experience with, financial statements and related processes. A principal executive officer with considerable operations involvement, but little financial or accounting involvement, likely would not be exercising the necessary active supervision; your experience must be with financial statements that present the breadth and level of complexity of accounting issues generally comparable to the breadth and complexity of the accounting issues that can reasonably be expected to be raised by the company's financial statements (although such experience need not be either in the same industry or with an Exchange Act reporting company).

e. Do you have an understanding of audit committee functions?

Yes  No

If your answer to Question 1.e is yes, please explain how you acquired the above understanding (include relevant positions, organizations, dates and job duties):

f. Have you taken formal courses related to financial or accounting matters?

Yes  No

If your answer to Question 1.f is yes, please describe (include name of course, name of institution and dates):

g. Do you hold any degrees relating to financial or accounting matters?

Yes  No

If your answer to Question 1.g is yes, please describe (include degree, name of institution and date of graduation):



*Model Audit Committee Member Financial Expertise  
and Independence Questionnaire E-7*

---

- h. Have you taught any courses or published any books or articles relating to financial or accounting matters?

Yes  No

If your answer to Question 1.h is yes, please describe (include name of courses, name of institution, dates of teaching, names of books or articles, publisher and dates of publication):

- i. Have you held any positions (such as CEO, CFO, controller, public accountant or auditor, principal accounting officer or any other position involving the performance of similar functions) that involved accounting, financial management, or the analysis and interpretation of financial statements?

Yes  No

If your answer to Question 1.i is yes, please describe (include relevant positions, dates of positions, and summary of duties of each position):

- j. Have you invested in an enterprise that required you to analyze or interpret financial statements?

Yes  No

If your answer to Question 1.j is yes, please describe (include the relevant investments and descriptions of the analyses or interpretations you performed with respect to them):

- k. Do you regularly read publications relating to financial or accounting matters?

Yes  No

If your answer to Question 1.k is yes, please describe (include content and length of time that you currently spend, and over the last five years have spent, on such activity):

- l. Do you engage, or have you engaged, in any other activities that relate to financial or accounting matters?

Yes  No

If your answer to Question 1.l is yes, please describe:

- m. Do you hold any financial or accounting-related professional certificates or licenses or are you a member in good standing of a financial or accounting-related professional association?

Yes  No

If your answer to Question 1.m is yes, please describe (include list of certificates and licenses, dates received and professional associations of which you are a member, including the length of time you have been a member in good standing of such associations):

- n. Please describe any other relevant qualifications or experience that would assist you in understanding and evaluating the Company's

financial statements and other financial information and other information that you believe would be appropriate for the Board of Directors to consider in determining your **Financial Literacy** or whether you are a **Financial Expert** within the meaning of the federal securities laws.

## 2. Independence

- a. Since [insert first day of last fiscal year], have you accepted, directly or indirectly,<sup>3</sup> any consulting, advisory or other compensatory fee<sup>4</sup> from the Company or any of its subsidiaries, other than fees for services rendered as a member of the Audit Committee, the Board of Directors or any other committee of the Board of Directors?

Yes  No

If your answer to Question 2.a is yes, please describe:

- b. Are you an **affiliate**<sup>5</sup> of the Company or any of its subsidiaries, other than in your capacity as a director of the Company? (Note: If you are not an executive officer or a holder of more than 10% of any class of the Company's voting securities, you should check "no.")

Yes  No

If your answer to Question 2.b is yes, please describe:

---

<sup>3</sup> "Indirect" acceptance of payments includes fees paid to your spouse, minor child or stepchild or a child or stepchild sharing a home with you. "Indirect" acceptance of payment also includes fees paid to an entity that provides accounting, consulting, legal, investment banking or financial advisory services to the company in which you are a partner, a member, an officer such as a managing director occupying a comparable position or executive officer, or you occupy a similar position (other than serving as a limited partner, non-managing member or similar position if, in each such case, you do not have an active role in providing services to the company).

<sup>4</sup> You do not need to report any compensation paid to you under a retirement plan (including deferred compensation) for prior service to the company so long as that compensation is not contingent in any way on continued service.

<sup>5</sup> You are an "affiliated person" of the company if you directly, or indirectly through one or more intermediaries, control, are controlled by, or are under common control with, the company. For purposes of this definition, "control" is defined as the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of the company, whether through the ownership of voting securities, by contract or otherwise.

**2A. Independence – NYSE-Listed Companies**

a.

- i. Are you now or have you at any point been within the last three years an employee of the Company (references to “the Company” in this Section 2A include any parent or subsidiary in a consolidated group with the Company)?

Yes  No

- ii. Is any member of your immediate family, or has any such individual been within the last three years, an executive officer of the Company?<sup>6</sup>

Yes  No

- iii. Have you or any member of your immediate family received more than \$100,000 during any 12-month period within the last three years in direct compensation (other than in director and committee fees and retirement or deferred pay for prior service (*provided* that such compensation is not contingent in any way on continued service) and compensation received by an immediate family member for service as a non-executive employee) from the Company?<sup>7</sup>

Yes  No

---

<sup>6</sup> For purposes of this question and the immediately following question, former service as an interim Chairman or CEO or other executive officer is not considered former service as an executive officer or employee of the company. If you are currently employed as an interim executive officer, you are considered a current executive officer and an employee of the company. Please separately disclose and describe in an attachment any former service to the company as an interim executive officer.

<sup>7</sup> Compensation you received for former service as an interim Chairman or CEO or other executive officer need not be included in the calculation, but please separately disclose and describe such compensation in an attachment.

iv. Are you or any member of your immediate family currently a partner of a firm that is the Company's internal or external auditor?

Yes  No

v. Are you currently an employee of a firm that is the Company's internal or external auditor?

Yes  No

vi. Is any member of your immediate family a current employee of a firm that is the Company's internal or external auditor and who participates in the firm's audit, assurance or tax compliance (but not tax planning) practice?

Yes  No

vii. Have you or has any member of your immediate family been a partner or employee of a firm that is the Company's internal or external auditor and personally worked on the Company's audit within the past three years?

Yes  No

viii. Have you or any member of your immediate family been employed within the last three years, or are you or any member of your immediate family currently employed, as an executive officer of another company where any of the Company's present executive officers at the same time served or serves on that company's compensation committee?

Yes  No

- ix. Are you now a current employee, or is any member of your immediate family a current executive officer, of an enterprise that has made or received payments to or from the Company for property or services in an amount that, in any of the last three fiscal years, exceeds the greater of \$1 million or 2% of the consolidated gross revenues of such enterprise?

Yes  No

**2B. Independence – NASDAQ-Listed Companies**

a.

- i. Are you now or have you at any point within the past three years been an employee of the Company or any parent or subsidiary of the Company?<sup>8</sup>

Yes  No

- ii. Have you or any member of your immediate family received during any 12-month period within the past three years more than \$100,000 in direct compensation (other than in director and committee fees, payments arising solely from investments in the Company's securities, compensation paid to a family member who is a non-executive employee of the Company or an affiliate and tax-qualified retirement or non-discretionary pay)?<sup>9</sup>

Yes  No

---

<sup>8</sup> For purposes of this question, former service as an interim Chairman or CEO or other executive officer is not considered service as an employee of the company as long as such interim employment did not last longer than one year. If you are currently employed as an interim executive officer, you are considered a current employee of the company. Please separately disclose and describe in an attachment any former service to the company as an interim executive officer.

<sup>9</sup> Compensation you received for former service as an interim Chairman or CEO or other executive officer need not be included in the calculation as long as such interim employment did not last longer than one year. Please separately disclose and describe in an attachment any compensation received while serving as an interim executive officer of the company.

- iii. Is any member of your immediate family, or has any such individual been at any point within the past three years, an executive officer of the Company or any parent or subsidiary of the Company?

Yes  No

- iv. Are you, or is any member of your immediate family, a partner in, a controlling shareholder of or an executive officer of an enterprise that makes or receives payments to or from the Company in the current or any of the past three fiscal years in an amount that exceeds the greater of \$200,000 or 5% of the recipient's consolidated gross revenues in that fiscal year?<sup>10</sup>

Yes  No

- v. Are you, or is any member of your immediate family, employed as an executive officer of another entity where at any time during the past three years any of the executive officers of the Company served on the compensation committee of such other entity?

Yes  No

- vi. Are you, or is any member of your immediate family, a current partner of the Company's independent auditor, or were you or any member of your immediate family a partner or employee of the Company's independent auditor who worked on the Company's audit at any time during any of the past three years?

Yes  No

---

<sup>10</sup> Payments arising solely from investments in the company's securities or payments under non-discretionary charitable contribution matching programs need not be included in the calculation.



*Model Audit Committee Member Financial Expertise  
and Independence Questionnaire E-15*

---

- vii. Have you participated at any point within the past three years in the preparation of the financial statements of the Company or any current subsidiary of the Company?

Yes  No

3. **Membership on Boards and Board Committees**

- a. Other than the Company, list any **Entity** (including any publicly held company and investment company registered under the Investment Company Act of 1940) of which you are or have been a member of such **Entity**'s board of directors and the relevant dates for your service on such board of directors.
  
- b. Other than the Company, list any **Entity** (including any publicly held company and investment company registered under the Investment Company Act of 1940) of which you are or have been a member of any committee (including audit committee) of such **Entity**'s board of directors and the relevant committees and dates for your service on any such committee.
  
- c. If not described above, please list all the audit committees on which you currently serve or have been selected to serve in the future.

**4. Other**

- a. Are you now or have you ever been the subject of any disciplinary action that could bear on your suitability as an Audit Committee member?

Yes  No

If your answer to Question 4.a is yes, please describe:

- b. Please provide any other information that you believe would be appropriate for the Board of Directors to consider in determining whether you are independent within the meaning of the federal securities laws and major securities markets listing standards.

**5. Name and Business Address**

### EXPLANATORY NOTE/DEFINITIONS

**Active Supervision** of a person who prepares, audits, analyzes or evaluates financial statements means:

- (1) More than mere traditional hierarchical reporting relationship.
- (2) Participation in, and contribution to, the process of addressing, at a supervisory level, the same general type of issues regarding preparation, auditing, analysis or evaluation of financial statements as those addressed by the person or persons being supervised.
- (3) Experience that has contributed to the general expertise necessary to prepare, audit, analyze or evaluate financial statements that is at least comparable to the general expertise of those being supervised.

**Affiliate** means “a person that directly or indirectly, through one or more intermediaries, controls or is controlled by, or is under common control with” a specified person or Entity. Two persons or Entities will be deemed to be affiliates if, by reason of the foregoing definition, they are affiliates of the same person or Entity at the same time. The term “**Affiliate**” includes a subsidiary, sibling company, predecessor, parent company, or former parent company.

**Entity** means a partnership, joint venture, corporation, trust, limited liability company, company or business entity, or other organization, whether for profit or not-for-profit.

**Financial Literacy** includes the ability to read and understand fundamental financial statements, including a company’s balance sheet, income statement, and cash flow statement.

**Immediate Family or Immediate Family Member** means an individual’s spouse, parents, children, brothers and sisters, mothers- and fathers-in-law, sons- and daughters-in-law, brothers- and sisters-in-law, and anyone (other than employees) who shares such individual’s home.

**ATTESTATION**

After reasonable investigation, I certify that, to the best of my information, knowledge and belief, the answers to these questions are true, correct and complete. I will promptly notify you of any change in the information set forth in this questionnaire after I become aware of any such change.

Signed: \_\_\_\_\_

Date: \_\_\_\_\_



## **Exhibit F**

### **MODEL POLICIES AND PROCEDURES WITH RESPECT TO RELATED PERSON TRANSACTIONS<sup>1</sup>**

#### **Introduction**

The Board of Directors of the Company (the “Board”) has adopted this Policy and the related procedures for the evaluation and approval, disapproval or ratification of Related Person Transactions (as defined below). This Policy is intended to establish a framework whereby such Related Person Transactions will be reviewed and approved or ratified by the Audit Committee.<sup>2</sup>

Under this Policy, a Related Person Transaction (as defined below) shall be consummated or continued only if the Audit Committee shall approve or ratify such transaction as in, or not inconsistent with, the best interests of the Company and its stockholders. This Policy is intended to augment and work in conjunction with other Company policies having code of conduct and/or conflict of interest provisions.

The Audit Committee of the Company periodically shall review this Policy and may recommend to the Board amendments to this Policy from time to time as it deems appropriate.

---

<sup>1</sup> Item 404(b) of Regulation S-K requires a company to disclose its policies and procedures for the review, approval or ratification of any related person transaction required to be reported under Item 404(a) of Regulation S-K. Item 404(b) further provides that, while the material features of such policies and procedures will vary depending on the particular circumstances, examples of such features may include, in given cases, among other things: (1) the types of transactions covered; (2) the standards to be applied and (3) the persons or groups of persons on the board or otherwise responsible for its application. The rule also provides that companies should disclose whether such policies and procedures are in writing and, if not, how such policies and procedures are evidenced.

<sup>2</sup> The NASDAQ marketplace rules require, and the New York Stock Exchange (NYSE) rules recommend, that the audit committee or another independent body of the board approve all related person transactions. *See* NYSE Listed company Manual Section 303.07 and NASDAQ Rule 4350(h). As such, a company may allocate such authority to a body of independent directors other than the audit committee.

## **Definitions**

For purposes of this Policy, a “Related Person” is:

1. Any Director or Executive Officer (as such terms are defined below) of the Company, and any individual who was a Director or Executive Officer of the Company at any time since the beginning of the last fiscal year.<sup>3</sup>
2. Any nominee for election as a Director of the Company.<sup>4</sup>
3. Any individual or entity known to the Company to be the beneficial owner of five percent (5%) or more of any class of the Company’s voting securities.<sup>5</sup>
4. Any immediate family member of an individual identified in Items 1 through 3 above. An immediate family member would be any child, stepchild, parent, stepparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law or sister-in-law of such individual, and any individual (other than a tenant or employee) sharing the household of such individual.<sup>6</sup>

For purposes of this Policy, a “Director” is a member of the Board, and an “Executive Officer” means an employee of the Company that is covered by Section 16a-1(f) of the Securities Exchange Act of 1934, as amended and in effect from time to time.

For purposes of this Policy, a “Related Person Transaction” is any transaction, arrangement or relationship (or series of similar transactions, arrangements or relationships) in which the Company (or any of its subsidiaries)<sup>7</sup> is, was or will be a participant and the amount involved exceeds \$120,000, and in which the Related Person had, has or will have a direct or indirect material interest,<sup>8</sup> other than:

---

<sup>3</sup> Instruction 1.a(i) to Item 404(a) of Regulation S-K.

<sup>4</sup> Instruction 1.a(ii) to Item 404(a) of Regulation S-K.

<sup>5</sup> Instruction 1.b(i) to Item 404(a) and Item 403(a) of Regulation S-K.

<sup>6</sup> Instructions 1.a(iii) and 1.b(ii) of Item 404(a) of Regulation S-K.

<sup>7</sup> SEC Release No. 33-8732A, Section V.A.1, text accompanying footnote 425.

<sup>8</sup> Item 404(a) of Regulation S-K.



- (a) Employment relationships or transactions involving an Executive Officer and any related compensation solely resulting from such employment if (i) the compensation is required to be reported in the company's annual proxy or (ii) the executive officer is not an immediate family member specified in subparagraph 4 in the definitions above and such compensation was approved, or recommended to the Board for approval, by the Compensation Committee of the Company.<sup>9</sup>
- (b) Compensation for serving as a Director of the Company.<sup>10</sup>
- (c) Payments arising solely from the ownership of the Company's equity securities in which all holders of that class of equity securities received the same benefit on a *pro rata* basis.<sup>11</sup>
- (d) Indebtedness arising from ordinary-course transactions such as the purchases of goods and services at market prices, and indebtedness transactions with any individual or entity that is a Related Person only by virtue of subparagraph 3 in the Definitions above.<sup>12</sup>
- (e) Transactions where the rates or charges are determined by competitive bids.<sup>13</sup>
- (f) Transactions where the rates or charges are fixed in conformity with law or governmental authority in connection with the provision of services as a common or contract carrier or public utility.<sup>14</sup>
- (g) Ordinary course transactions involving the provision of certain financial services (*e.g.*, by a bank depository, transfer agent, registrar, trustee under a trust indenture or similar services).<sup>15</sup>

---

<sup>9</sup> Instruction 5 of Item 404(a) of Regulation S-K.

<sup>10</sup> Instruction 5 of Item 404(a) of Regulation S-K.

<sup>11</sup> Instruction 7.c of Item 404(a) of Regulation S-K.

<sup>12</sup> Instruction 4 of Item 404(a) of Regulation S-K.

<sup>13</sup> Instruction 7.a of Item 404(a) of Regulation S-K.

<sup>14</sup> Instruction 7.a of Item 404(a) of Regulation S-K.

<sup>15</sup> Instruction 7.b of Item 404(a) of Regulation S-K.

### **Review and Approval of Related Person Transactions**

Management shall present to the Audit Committee of the Company the following information, to the extent relevant, with respect to actual or potential Related Person Transactions:

1. A general description of the transaction(s), including the material terms and conditions.
2. The name of the Related Person and the basis on which such individual or entity is a Related Person.<sup>16</sup>
3. The Related Person's interest in the transaction(s), including the Related Person's position or relationship with, or ownership of, any entity that is a party to or has an interest in the transaction(s).<sup>17</sup>
4. The approximate dollar value of the transaction(s), and the approximate dollar value of the Related Person's interest in the transaction(s) without regard to amount of profit or loss.<sup>18</sup>
5. In the case of a lease or other transaction providing for periodic payments or installments, the aggregate amount of all periodic payments or installments expected to be made.<sup>19</sup>
6. In the case of indebtedness, the aggregate amount of principal to be outstanding and the rate or amount of interest to be payable on such indebtedness.<sup>20</sup>
7. Any other material information regarding the transaction(s) or the Related Person's interest in the transaction(s).<sup>21</sup>

After reviewing such information, the disinterested members of the Audit Committee of the Company shall approve or disapprove such transaction. No member of the Audit Committee of the Company shall participate in the review, consideration or approval of any Related Person Transaction with respect to

---

<sup>16</sup> Item 404(a)(1) of Regulation S-K.

<sup>17</sup> Item 404(a)(2) of Regulation S-K.

<sup>18</sup> Item 404(a)(3)-(4) of Regulation S-K.

<sup>19</sup> Instruction 3.b of Item 404(a) of Regulation S-K.

<sup>20</sup> Item 404(a)(5) and Instruction 3.a of Item 404(a) of Regulation S-K.

<sup>21</sup> Item 404(a)(6) of Regulation S-K.

which such member or any member of his or her immediate family is a Related Person. Approval of such transaction shall be given only if it is determined by the Audit Committee of the Company that such transaction is in, or not inconsistent with, the best interests of the Company and its shareholders.

If any material information with respect to such transactions shall change subsequent to the Audit Committee of the Company's review of such transactions, management shall provide the Audit Committee of the Company with updated information at its next scheduled meeting.

In the event management becomes aware of a Related Person Transaction that has not been previously approved or ratified under this Policy, it shall be submitted to the Audit Committee of the Company promptly, and the Audit Committee of the Company shall review the Related Person Transaction in accordance with the criteria set forth in this Policy, taking into account all of the relevant facts and circumstances available to the Audit Committee of the Company. Based on the conclusions reached, the Audit Committee of the Company shall evaluate all options, including, without limitation, approval, ratification, amendment or termination of the Related Person Transaction or, with respect to any Related Person Transaction that is no longer pending or ongoing, rescission and/or disciplinary action. Any such determination by the Audit Committee of the Company shall be reported to the full Board.

In the event management determines it is impractical or undesirable to wait until the next meeting of the Audit Committee of the Company to approve a Related Person Transaction, the Chair of the Audit Committee of the Company may review and approve the Related Person Transaction in accordance with the criteria set forth herein. The Chair of the Audit Committee of the Company will report any such approval to the Audit Committee of the Company at its next regularly scheduled meeting.

The Audit Committee of the Company shall report all material Related Person Transactions it has reviewed to the full Board.