Counsel for
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Acredula

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Acredula is the Latin word for "owl," connoting wisdom. This newsletter is intended as wise counsel for boards and executives.

New Rules Governing Audit Committees Will Impact Board Members and Executives

Editor's Note

This issue continues our focus on matters of importance in the boardroom. In December 1999, new audit committee rules were finalized. These rules may have the most far-reaching effect of any rules since the formation of the capital markets. We think the new audit committee rules will apply to every organization that separates management from ownership, whether privately or publicly held, taxable or tax-exempt, or for-profit or non-profit. We also think the concepts of independence and competence now required for audit committees will apply equally to the other oversight committees of a governing board.

One of the leaders in the accounting profession in analyzing the new audit committee rules has been the firm of KPMG LLP. KPMG has formed an Audit Committee Institute and is working with the Conference Board, NACD and others to educate directors and companies on these new rules. For more information on audit committee issues, visit KPMG's website at www.us.kpmg.com/auditcommittee.

We are pleased that our feature article in this issue of *Acredula* was authored by Jon Eesley, managing partner of the Columbus, Ohio office of KPMG. Jon's article explains the significant changes made by the new audit committee rules. Jon and his KPMG colleagues can be reached by calling (614) 249-2305 or by writing to Two Nationwide Parkway, Columbus, Ohio 43215.

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Following Jon's feature article is a contribution of our own discussing the likely far-reaching impact of the audit committee rules on other oversight committees.

This past March, Ohio was fortunate to host the 2000 Spring Meeting of the American Bar Association's Section of Business Law. A number of issues of importance to board and executives were discussed at that meeting. Our May issue of *Acredula* will summarize some of the current trends in both boardrooms and executive suites discussed at the 2000 Spring Meeting.

New Regulations Bring Significant Changes to Audit Committee Governance

By Jon Eesley, Managing Partner, KPMG

In September 1998, the formation of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees (BRC) began the long process of formal rule changes by stock exchanges, the Securities Exchange Commission (SEC) and the American Institute of Certified Public Accountants (AICPA). After proposing rule

reforms over the last few months, these organizations finalized the new audit committee rules in December 1999.

The newly established rules will not affect the governance practices of companies that already have effective audit committees, except for incremental disclosures. Companies lacking effective audit committees, however, will be required to recruit new directors, establish new audit committee processes and enhance communications with management and auditors.

The final rules are generally consistent with the original BRC recommendations with the following significant modifications:

- There are no exemptions for companies with market capitalization below $200 million.
- Instead of addressing generally accepted accounting principles, an audit committee's report to its shareholders requires a recommendation that the financial statements be included in Form 10-K.
- Exchanges have defined independence for audit committee members.
- Exchanges require written affirmation of compliance with independence, financial literacy and charter rules.
- The SEC requires disclosure of the charter if the board of directors has adopted one, but does not require disclosure of compliance with that charter.
- Although auditors should comment on both the quality and the acceptability of the company's accounting principles, they are not required to indicate the aggressiveness or conservatism of those accounting principles.
- Quarterly reviews are required by auditors, but discussion with audit committees is only necessary if certain matters are identified during these reviews.

Companies lacking effective audit committees, however, will be required to recruit new directors, establish new audit committee processes and enhance communications with management and auditors.

Audit Committee Composition. Establishing a higher standard of qualifications for audit committee membership was a primary goal of the BRC. The exchanges require that audit committees be comprised of at least three independent, financially literate directors, one of whom must have accounting or related financial management expertise. Some companies are in the process of searching for individuals with a higher level of financial expertise, such as CEOs with financial adeptness, CFOs, and retired audit partners.

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Report to Shareholders. During the reform process, the most controversial rule proposal concerned the audit committee's report to its shareholders. The SEC made significant compromises from not only the original BRC recommendation, which required a report from the audit committee on generally accepted accounting principles, but also from its own proposal, which required negative assurance. Beginning December 15, 2000, the annual proxy statement must include an audit committee report stating whether the committee has reviewed the audited financial statements with management and discussed certain matters with the auditors. The report must state whether the audit committee recommended to the board of directors that the audited financial statements be included in the company's annual report on form 10-K. For most companies, the report is not required until the spring of 2001.

Charters. According to the new rules, the annual proxy statement must also state whether the audit committee has adopted a written charter. A copy of this charter must be included in the proxy statement at least every three years. Establishing a meaningful, tailored charter is important for all audit committees. Each audit committee and board should update its charter annually. Charters should be reviewed by outside counsel and auditors prior to adoption. Boards and audit committees must ensure that the charter includes all required responsibilities and that all responsibilities stated within the charter are met.

Quarterly Reviews. The SEC is requiring that auditors perform timely quarterly reviews of all public companies, but there is no obligation for the audit committees to review the quarterly financial statements. If certain matters are identified during the interim review, the auditor must be satisfied that they have been communicated to the audit committee. Therefore, quarterly communications may not be required.

Audit Committee Oversight of External Auditors. Outside auditors must disclose all relationships with the company that the auditor believes may impact independence and objectivity. The auditor must also discuss with the audit

committee the quality, not just the acceptability, of the company's accounting principles. This discussion should involve management and should include such matters as the consistency, clarity, and completeness of accounting policies and disclosures. These discussions will be required for years ending December 31, 2000 and later.

While many directors were concerned that the new rules would significantly increase the risks and responsibilities of audit committee members relative to other directors, the final rules represent compromises that will ultimately enhance their effectiveness without significantly increasing the risks.

New Audit Committee Rules May Have Far-Reaching Impact

By John P. Beavers, Bricker & Eckler LLP

Although the new audit committee rules established on the recommendation of the Blue Ribbon Committee apply only to organizations with publicly traded securities, the rules will likely have a much farther reaching impact. Any provider of capital will likely require compliance with the same or similar rules by any organization, for-profit or non-profit, taxable or tax-exempt, whose management is separate from its owners. Just as public investors have pressured the SEC, NYSE, NASD and AMEX to require compliance with rules on the independence, competence and authority of audit committees, venture capitalists, institutional investors, commercial lenders and other providers of capital are likely to require similar compliance. The definition of independence, standard of competence and determination of authority established by the new audit committee rules are equally applicable to any oversight committee, including compensation and nominating committees. Because the NASD/AMEX rules will govern the greatest number of organizations, they will most likely become the standard for all oversight committees of all organizations.

Independence. Under the NASD/AMEX rules, each audit committee member must be an independent outsider - a person other than an officer or employee of the company or its subsidiaries or any other individual having a relationship which might interfere with exercising independent judgment in carrying out the responsibilities of a director. The rules provide that the following types of directors are excluded from independence:

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- A director recently or currently employed by the corporation or any of its affiliates.
- An immediate family member of a current or recent executive officer of the corporation.
- Someone who accepts any compensation from the corporation or any of its affiliates in excess of $60,000 during the previous fiscal year, other than compensation for board service, benefits under a tax-qualified retirement plan, or non-discretionary compensation.
- A shareholder, partner, or executive officer of any for-profit business who has received payments of a certain value that resulted from a recent business transaction with the corporation.
- An executive of another entity where any of the company's executives serve on that entity's compensation committee.

The definition of independence, standard of competence and determination of authority established by the new audit committee rules are equally applicable to any oversight committee, including compensation and nominating committees.

Public investors as well as other providers of capital are likely to apply the same definition of "independence" in determining the composition of other oversight committees, such as compensation and nominating committees.

Competence. The NASD/AMEX rules require that, within a reasonable period of appointment to the audit committee, each member must be able to read and understand financial statements, including the organization's balance sheet, income statement,

and cash flow statement. In addition, at least one member must have:

- Past employment experience in finance or accounting;
- Requisite professional certification in accounting; or
- Other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

The new audit committee regulations may have the most far-reaching effect of any rules since the formation of the capital markets.

Public investors and other providers of capital are likely to apply similar standards of "competence" in determining the composition of other oversight committees. For example, members of compensation committees should be familiar with executives' compensation methods and be able to read and understand compensation plans and employment agreements. Members of nominating committees should have a general understanding of the duties and responsibilities of directors and be familiar with persons having the experience and skill to serve as such.

Authority. In order to assure public investors and other providers of capital that an audit committee exists and remains part of the organization's structure, the NASD/ AMEX rules require a formal written charter specifying the scope of the audit committee's responsibilities. Public investors and providers of capital are also likely to require a formal written charter specifying those responsibilities for each of the other oversight committees as well.

Enforcement. On behalf of public investors, NASD and AMEX will enforce the recent audit committee rules as a condition to listing or quoting transactions in the organization's securities. Other providers of capital are likely to enforce compliance to similar rules as contractual conditions to obtaining capital. These provisions will probably become common in stock purchase agreements, venture capital agreements, debt instruments and even loan agreements. Additionally, market makers and other business associates are likely to require disclosures similar to the SEC requirements for organizations with publicly traded securities.

The recent audit committee rules will touch more than just organizations with publicly traded securities in the United States. These rules could impact every organization that is in or will enter any of the capital markets of the United States, including all forms of organizations where management is separate from the providers of capital. Although these rules target audit committees, similar definitions and standards are equally applicable to the compensation, nominating and other oversight committees. With this in mind, the new audit committee regulations may have the most far-reaching effect of any rules since the formation of the capital markets.

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