

Audit Committees: Public, Private & Nonprofit

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Broad Overview:

Understanding the standards of care and responsibility update.
Whose responsibility is it, and what is the responsibility?

Yes, getting the job done diligently and safely—obtaining information and help from other people—communications—prudent reliance—a process proposal.

Lessons learned from the current environment and financial crisis.

New developments—looking ahead—discussion hypotheticals.

Primary Topic Areas—Audit Committees: Public, Private & Nonprofit:

Understanding and satisfying the standards of care and responsibilities:

The business judgment rule;

Statutory, regulation and rule qualifications, composition, and responsibilities;

Select cases.

Interacting—obtaining information and help from other people—prudent reliance—communications—the outside auditor, CFO, internal audit, ethics/compliance, etc.

The audit committee charter.

Meeting processes, the agenda, decision making and documentation.

Hypotheticals and interactive discussion.

Lessons learned from the current environment and financial crisis—new developments and looking ahead.

Benefiting from an annual evaluation.

Yes, getting the job done diligently and safely—a process proposal.

Disclaimer:

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The Business Judgment Rule:

The audit committee is a sub-committee of the board. Members of the committee are directors. The business judgment rule applies to directors, and thus provides a standard of care for the audit committee. The business judgment rule provides a director with a defense to personal liability, holding that as a general principle of law a director or audit committee member who satisfies the business judgment rule has satisfied his or her duties. In some states the business judgment rule is codified by statute, such as Cal. Corp. Code §309; in other states the rule is established by case law.

In summary, as a general principle the business judgment rule provides that a director should undertake his or her duties:

- In good faith, with honesty and without self-dealing or improper personal benefit;
- In a manner that the committee member believes to be in the best interests of the corporation and its shareholders; and
- With the care, including reasonable inquiry, that an ordinarily prudent person in a like position would use under similar circumstances.

Reliance Upon Other People Under the Business Judgment Rule:

In the course and scope of performing his or her duties, an audit committee member must necessarily obtain information from and rely upon other people. The audit committee member is not involved in the day-to-day operations of the business. The audit committee member provides an oversight function. Pursuant to the business judgment rule, a director or audit committee member is entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, prepared or presented by any of the following:

-Officers or employees of the corporation whom the director believes to be reliable and competent in the relevant matters;

-Legal counsel, independent accountants or other persons as to matters that the director believes are within the person's professional or expert competence; or

-A committee of the board on which the director does not serve, as to matters within that committee's designated authority, so long as the director acts in good faith, after reasonable inquiry as warranted by the circumstances, and without knowledge that would cause reliance to be unwarranted.

The Business Judgment Rule for California Nonprofits:

California Corporations Code §5231, for nonprofit public benefit corporations, and §7231, for nonprofit mutual benefit corporations, in pertinent part provide that:

(a) A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

Reliance Upon Other People Under the Business Judgment Rule for California Nonprofits:

California Corporations Code §5231, for nonprofit public benefit corporations, and §7231, for nonprofit mutual benefit corporations, in pertinent part provide that:

(b) In performing the duties of a director, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by: (1) one or more officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented; (2) counsel, independent accountants or other persons as to matters which the director believes to be within such person's professional or expert competence; or (3) a committee of the board upon which the director does not serve, as to matters within its designated authority, which committee the director believes to merit confidence, so long as, in any such case, the director acts in good faith, after reasonable inquiry when the need therefor is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted.

The Business Judgment Rule for California Nonprofit Religious Corporations:

California Corporations Code §9241 contains similar language for nonprofit religious corporations. However, §9241 replaces ". . . as an ordinarily prudent person in a like position would use under similar circumstances", with ". . . as is appropriate under the circumstances." Section 9241 also allows for appropriate reliance on "religious authorities and ministers, priests, rabbis, or other persons"

Qualifications and Composition, Federal Statutes and Regulations:

Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) Section 301, Public Company Audit Committees, and related Section 10A of the Securities Exchange Act of 1934 and SEC Rule 10A-3, require that each member of the audit committee shall be a member of the board of directors and shall be independent. To be independent, an audit committee member, other than in his or her capacity as a member of the board of directors, the audit committee, or any other board committee, may not accept any consulting, advisory or other compensatory fee from the company, or be an affiliated person of the company or any subsidiary of the company.

Qualifications and Composition, Federal Statutes and Regulations (continued):

Sarbanes-Oxley §407, Public Company Audit Committees—Disclosure of Audit Committee Financial Expert, directs the SEC to issue rules requiring each issuing company to disclose whether or not, and if not, why not, the audit committee of that company has at least one member who is a financial expert. Section 407 further states that the SEC shall consider whether the person has, through education and experience as a public accountant or auditor or a principal financial officer, comptroller, or principal accounting officer of an issuer, or from a position involving the performance of similar functions:

- An understanding of generally accepted accounting principles and financial statements;
- Experience in the preparation or auditing of financial statements of generally comparable companies, and the application of generally accepted accounting principles in connection with accounting for estimates, accruals, and reserves;
- Experience with internal accounting controls; and
- An understanding of audit committee functions.

See also SEC Regulation S-K, Item 407 which further defines “financial expert.”

Qualifications and Composition, NYSE Listed Company Manual:

New York Stock Exchange (NYSE) Listed Company Manual §303A.06, Audit Committee Requirement, requires that each listed company have an audit committee that satisfies the requirements of SEC Rule 10A-3.

Pursuant to NYSE Listed Company Manual §303A.07, Audit Committee Composition and Other Requirements, the audit committee must have a minimum of three members, and in addition to any requirement of SEC Rule 10A-3(b)(1) of the Securities Exchange Act, each audit committee member must satisfy the independence requirements stated in NYSE Listed Company Manual §303A.02.

Each audit committee member must be financially literate, and at least one audit committee member must have accounting or related financial management expertise; each member also must have sufficient time available to perform the functions and responsibilities of an audit committee member. NYSE Listed Company Manual §303A.07.

Qualifications and Composition, NASDAQ Stock Market Rules:

NASDAQ Marketplace Rule 4350(d)(2), Audit Committee Composition, requires that each issuer have an audit committee that is comprised of at least three members, each of whom must be independent and meet the independence rules set forth in SEC Rule 10A-3(b)(1) of the Securities Exchange Act; must not have participated in the preparation of the financial statements of the company or any current subsidiary of the company during the past three years; and must be able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement. At least one member of the audit committee must have past employment experience in finance or accounting; requisite professional certification in accounting; or any other comparable experience or background which results in that person's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities.

Qualifications and Composition, California Nonprofits:

With respect to nonprofit audit committees, the California Nonprofit Integrity Act at Cal. Gov. Code §12586 applies to specified charitable corporations, associations and trustees, that receive or accrue in any fiscal year gross revenues of \$2,000,000 or more (exclusive of grants from, and contracts for services with, governmental entities for which the government requires an accounting of the funds received). The Office of the Attorney General has stated that for the purpose of the Act, gross revenue is the same as total revenue which appears on Line 12 of IRS Form 990 for public charities, and Line 12, column (a) for private foundations (follow Form 990 and 990PF instructions).

Each such nonprofit must have an audit committee appointed by the board of directors. The audit committee may include people who are not members of the board, but may not include any members of the staff, including the president, chief executive officer, treasurer or chief financial officer. If the charitable corporation has a finance committee, the audit committee must be separate from the finance committee. Members of the finance committee may serve on the audit committee, but the chair of the audit committee may not be a member of the finance committee, and finance committee members must comprise less than one-half of the membership of the audit committee. There is no requirement that there be a particular number of audit committee members.

Qualifications and Composition, California Nonprofits (continued):

Members of the audit committee cannot receive any compensation from the charity in excess of the compensation, if any, received by members of the board for service on the board, and shall not have a material financial interest in any entity doing business with the charity.

Responsibilities, Federal Statutes and Regulations:

Sarbanes-Oxley §301, Public Company Audit Committees, and related Section 10A of the Securities Exchange Act of 1934 and SEC Rule 10A-3, require that:

-The audit committee (as a committee of the board) is responsible for the appointment, compensation and oversight of the outside auditor (including resolution of disagreements between management and the auditor regarding financial reporting).

-The outside auditor must report directly to the audit committee.

-The audit committee is authorized to hire independent counsel and other advisers to help the committee perform its duties. The company must provide funding, as determined by the audit committee, for compensation of the outside auditor, to compensate advisers employed by the audit committee, and to pay the administrative expenses of the audit committee.

-The audit committee must establish procedures for the receipt, retention, and treatment of complaints received by the company regarding accounting, internal accounting controls, or auditing matters; and for confidential, anonymous submission by company employees of concerns about questionable accounting or auditing matters.

Responsibilities, Federal Statutes and Regulations (continued):

SEC Regulation S-K, Item 407, Public Company Audit Committees, requires that the audit committee must disclose whether it has reviewed and discussed the audited financial statements with management; discussed with the outside auditor the matters covered by Statement on Auditing Standards (SAS) No. 114; received the written disclosures and the letter from the outside auditor required by Independence Standards Board No. 1; and recommended to the board of directors that the audited financial statements be included in the company's annual report for filing with the SEC. SEC Regulation S-K, Item 407 in part also requires the company to disclose whether or not the audit committee has a charter. See also SEC Regulation S-K, Item 304, which requires the company to provide detailed disclosures in certain circumstances when there is, or has been during the two most recent fiscal years, a change in the outside auditor that was engaged to audit the financial statements of the company or of a significant subsidiary of the company.

Responsibilities, Federal Statutes and Regulations (continued):

Sarbanes-Oxley §302, Corporate Responsibility for Financial Reports, requires the chief executive and chief financial officers to certify their knowledge of the truth of each annual and quarterly report, their responsibility for designing, establishing, maintaining and evaluating the effectiveness of internal controls, and whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions relating to significant deficiencies and material weaknesses. The signing officers also must state that they have disclosed to the company's outside auditor and the audit committee all significant deficiencies in the design or operation of internal controls that could adversely affect the company's ability to record, process, summarize, and report financial data, and have identified for the company's outside auditor any material weaknesses in internal controls; and any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal controls.

Responsibilities, Federal Statutes and Regulations (continued):

Sarbanes-Oxley §404, Management Assessment of Internal Controls, and related SEC Regulation S-K, Item 308, Internal Control Over Financial Reporting (as amended), require each annual report to contain a statement of management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting; a statement identifying management's framework used to evaluate the effectiveness of the company's internal control over financial reporting, and an opinion by the outside auditor on the effectiveness of internal control over financial reporting to protect against the risk of material financial misstatement (an opinion regarding management's evaluation process is no longer required).

Regulation S-K, Item 308 also requires the disclosure of any change in the company's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

Responsibilities, Federal Statutes and Regulations (continued):

Sarbanes-Oxley §404, Management Assessment of Internal Controls, and related SEC Regulation S-K, Item 308, Internal Control Over Financial Reporting (as amended) (continued).

The term “internal control over financial reporting” is defined as a process designed by, or under the supervision of, the company’s principal executive and principal financial officers, and effected by the company’s board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

The SEC defines the term “material weakness” as “a deficiency, or combination of deficiencies, in internal control over financial reporting, 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.”

Responsibilities, Federal Statutes and Regulations (continued):

Auditor Independence and Services:

Sarbanes-Oxley §201, Services Outside the Scope of Practice of Auditors, and related Section 10A of the Securities Exchange Act of 1934, provide that a public accounting firm may not provide to an issuer contemporaneously with the audit, any non-audit service, including:

- Bookkeeping or other services related to the accounting records or financial statements of the audit client;
- Financial information systems design and implementation;
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;
- Actuarial services;
- Internal audit outsourcing services;

Responsibilities, Federal Statutes and Regulations (continued):

Auditor Independence and Services (continued):

Sarbanes-Oxley §201, Auditor Independence and Services, Services Outside the Scope of Practice of Auditors (continued):

-Management functions or human resources;

-Broker or dealer, investment adviser, or investment banking services;

-Legal services and expert services unrelated to the audit; and

-Any other service that the Public Company Accounting Oversight Board determines, by regulation, is impermissible.

However, the outside auditor may be engaged to provide a non-audit service, including tax services, that is not described in the bulleted list above, but only if the activity is approved in advance by the audit committee in accord with the provisions of §202.

Responsibilities, Federal Statutes and Regulations (continued):

Auditor Independence and Services (continued):

Sarbanes-Oxley §202, Preapproval Requirements, requires that all auditing services (which may include comfort letters), and allowable non-auditing services provided to an issuer company by the outside auditor must be preapproved by the company's audit committee. Section 202 also specifies additional criteria that must be met to satisfy the preapproval process.

Sarbanes-Oxley §203, Audit Partner Rotation, provides that the public accounting firm may not provide audit services to an issuer company 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 company in each of the five previous fiscal years.

Sarbanes-Oxley §206, Conflicts of Interest, provides that it is unlawful for a public accounting firm to perform any audit service if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the company, was employed by that accounting firm and participated in any capacity in the audit of that company during the one-year period preceding the date of the initiation of the audit.

Responsibilities, NYSE Listed Company Manual:

NYSE Listed Company Manual §303A.06, Audit Committee Requirement, requires each listed company to have an audit committee that satisfies the requirements of SEC Rule 10A-3 of the Securities Exchange Act.

NYSE Listed Company Manual §303A.07, Additional Requirements of the Audit Committee, contains the following additional audit committee requirements:

The audit committee must have a written charter that addresses:

1. The committee's purpose which, at minimum, must be to:

-Assist the board's oversight of the integrity of the company's financial statements, the company's compliance with legal and regulatory requirements, the outside auditor's qualifications and independence, and the company's internal audit function and outside auditors; and

-Prepare an audit committee report as required by the SEC to be included in the company's annual proxy statement;

Responsibilities, NYSE Listed Company Manual (continued):

2. An annual performance evaluation of the audit committee; and

3. The duties and responsibilities of the audit committee which, at a minimum, must include the requirements of SEC Rule 10A-3(b)(2)-(5) of the Securities Exchange Act and to also:

-At least annually, obtain and review a report by the outside auditor describing: (1) the firm's internal quality-control procedures; (2) 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 preceding five years, and any steps taken to deal with any such issues; and (3) to assess the auditor's independence and all relationships between the outside auditor and the company.

Commentary to §303A.07 states that the audit committee should evaluate the auditor's qualifications, performance and independence.

Responsibilities, NYSE Listed Company Manual (continued):

- Discuss the company's annual audited financial statements and quarterly financial statements with management and the outside auditor, including reviewing the company's disclosures under Management's Discussion and Analysis of Financial Condition and Results of Operations.
- Discuss the company's earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies.
- Discuss policies with respect to risk assessment and risk management.
- Meet separately and periodically with management, the internal auditors (or other personnel responsible for the internal audit function), and the outside auditor.

Responsibilities, NYSE Listed Company Manual (continued):

- Review with the outside auditor any audit problems or difficulties and management's response.
 - Set clear hiring policies for employees or former employees of the outside auditor.
 - Report regularly to the board of directors, and review with the full board any issues that arise with respect to the quality or integrity of the company's financial statements, the company's compliance with legal or regulatory requirements, the performance and independence of the company's outside auditor, and the performance of the internal audit function.
4. Each listed company must have an internal audit function.

See also additional general Commentary to §303A.07 discussing in greater detail the audit committee's responsibilities to review items relating to accounting principles, internal controls, off-balance sheet items, pro forma information, and other matters.

Responsibilities, NASDAQ Stock Market:

NASDAQ Marketplace Rule 4350(d)(1), Audit Committee Charter, requires each issuer company to certify that it has a written audit committee charter and that the audit committee has annually reviewed and reassessed the adequacy of the charter.

The charter must specify:

- The scope of the audit committee's responsibilities, and how it carries out those responsibilities,
- The audit committee's responsibility to review, evaluate and oversee the outside auditor's independence, and receive from the outside auditor a written statement disclosing all relationships between the auditor and the company, in accord with Independence Standards Board Standard No. 1.
- The committee's purpose of overseeing the accounting and financial reporting processes, and audits of the financial statements of the company.
- The committee responsibilities and authority specified in NASDAQ Marketplace Rule 4350(d)(3).

Responsibilities, NASDAQ Stock Market (continued):

NASDAQ Marketplace Rule 4350(d)(3), Audit Committee Responsibilities and Authority, specifies that the audit committee must have and satisfy the specific audit committee responsibilities and authority necessary to comply with SEC Rule 10A-3(b)(2)-(5) of the Securities Exchange Act, relating to the outside auditor firm; complaints relating to accounting, internal accounting controls or auditing matters; authority to engage advisers; and funding.

NASDAQ Marketplace Rule 4350(h), Conflicts of Interest, requires that each company conduct a review of all related party transactions for potential conflicts of interest on an ongoing basis. All such transactions must be approved by the audit committee or another independent body of the board of directors. See SEC Regulation S-K, Item 404 for the definition of the term “related party transaction.”

Responsibilities, California Nonprofits:

-The California Nonprofit Integrity Act (Cal. Gov. Code §12586) applicable for nonprofits that receive or accrue in any fiscal year gross revenues of \$2,000,000 or more, requires that the nonprofit maintain financial statements that are in accord with generally accepted accounting principles, and that the financial statements be audited by an independent outside auditor in accordance with generally accepted auditing standards, and, where applicable, in accord with the Government Auditing Standards, U.S. Comptroller General, Yellow Book. The audited financial statements and the notes to the statements (but not the management letter) must be released to the public.

-Subject to the board's supervision, the audit committee shall recommend the retention and termination of the outside auditor, and may negotiate the outside auditor's compensation on behalf of the board.

-The audit committee shall confer with the outside auditor that the financial affairs of the nonprofit are in order, and shall review and determine whether to accept the audit, shall assure that any non-audit services performed by the outside auditor conform with outside auditor independence standards, and shall approve the performance of any non-audit services.

Select Recent Cases Discussing Audit Committee Diligence:

In re Hollinger International, Inc. Securities Litigation (ND Ill. 2006), holding that while outside director audit committee members are not charged with guaranteeing the accuracy of all financial statement information, their lack of oversight can at least indicate recklessness.

In re WorldCom, Inc. Securities Litigation (SD NY 2005), holding that whereas audited financial statements are considered to be based on the authority of an expert (the outside auditor), unaudited (reviewed) financial statements are not considered to be based on the authority of the expert, and, with respect to unaudited quarterly financial statements, the director may have a higher duty of diligent investigation. The court held that reliance on the statements of others did not present a sufficient evidentiary showing of due diligence, especially when combined with a lack of evidence indicating diligent response to red flags.

In re Chancellor Corp. (SEC Litigation Release April 2003), in which the SEC charged outside directors and the audit committee chair with fraud, ignoring warning signs of financial improprieties, failure to act on warning signals of improper accounting practices, and ignoring that the auditors had been replaced because of their disagreement with the company's accounting practices.

Select Recent Cases Discussing Audit Committee Diligence (continued):

In re Hayes Lemmerz International, Inc. Equity Securities Litigation (ED Mich. 2003), holding that the case against the independent audit committee members could go forward based on relatively general allegations about the responsibilities of the audit committee found in statutory authorities, the audit committee's charter, and the financial statements. The court held that the plaintiffs had sufficiently alleged that the audit committee was responsible for oversight of management's accounting, the financial statements, and internal controls.

In re Digi International, Inc. Securities Litigation (8th Cir. 2001), holding that active corporate and board diligence and assistance from the outside auditor and competent outside legal counsel tend to negate allegations of mental intent to commit wrongdoing.

Required Communications From the Outside Auditor.

Sarbanes-Oxley §204, Auditor Report to Audit Committee, and related Section 10A of the Securities Exchange Act of 1934, require that the outside auditor timely report to the audit committee:

- All critical accounting policies and practices to be used;

- All alternative treatments of financial information within generally accepted accounting principles that have been discussed with management, ramifications of the use of alternative disclosures and treatments, and the treatment preferred by the outside auditor; and

- Other material written communications between the outside auditor and management, such as any management letter or schedule of unadjusted differences.

Required Communications From the Outside Auditor (continued):

Statement on Auditing Standards (SAS) 114, Auditor's Communications with those Charged with Governance, requires the outside auditor to determine that certain matters relating to the audit of the financial statements are communicated to those charged with governance, which at least includes the audit committee, and may include the board of directors.

-The auditor should have access to the audit committee, the chair and other members of the audit committee should meet with the auditor periodically, and the audit committee should meet with the auditor without management present at least annually.

-The auditor must communicate regarding the auditor's responsibilities under generally accepted auditing standards; the planned scope, performance and timing of the audit (including matters relating to internal controls); the extent that the auditor may use work of internal audit or outside accountants; and significant findings from the audit including but not limited to possible fraud, possible illegal acts, material deficiencies or errors, significant difficulties, qualitative aspects of the accounting practices, uncorrected misstatements, disagreements with management, material corrected misstatements, and other significant issues that come to the auditor's attention.

Required Communications From the Outside Auditor (continued):

Statement on Auditing Standards 114, Auditor's Communications with those Charged with Governance (continued):

-Other matters that the auditor may consider discussing with the audit committee include the committee members' views about the company's governance; objectives and strategies relating to risks that may result in material misstatement; internal controls and the committee's oversight of internal controls; the possibility of fraud; communications with regulators; the committee's actions in response to previous communications with the auditor; the committee's actions in response to developments in financial reporting, laws, accounting standards, and corporate governance practices; and other matters that the audit committee members believe are relevant to the audit of the financial statements.

-The auditor should evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. Inadequate two-way communications may indicate an unsatisfactory control environment, which may influence the auditor's assessment of the risks of material misstatement, or the auditor's ability to perform that audit.

Required Communications From the Outside Auditor (continued):

Statement on Auditing Standards 54, *Illegal Acts by Clients*, requires that the outside auditor design the audit to provide reasonable assurance that illegal acts that would have a direct and material effect on the financial statements will be detected. SAS 54 further provides that the outside auditor must be sure that the audit committee is adequately informed about illegal acts that come to the auditor's attention, and discusses the possible impact that the discovery of illegal acts may have for reporting and audit opinion purposes.

See also, Section 10A of the Securities Exchange Act of 1934 which requires that the audit committee must include procedures designed to detect illegal acts that would have a direct and material effect on the financial statement amounts, procedures to identify material related party transactions, and procedures to evaluate whether there is a substantial doubt about the ability of the entity to continue as a going concern; and procedures relating to the handling and possible reporting of illegal acts.

Required Communications From the Outside Auditor (continued):

Statement on Auditing Standards 99, Consideration of Fraud in a Financial Statement specifies that:

-The outside auditor must ask management about knowledge or allegations of any fraud or suspected fraud; management's understanding about the risks of fraud; programs and controls established to mitigate specific identified fraud risks, or that prevent, deter, and detect fraud, and how management communicates to employees its views on business practices and ethics; and whether management has reported to the audit committee on how the company's internal control serves to prevent, deter, or detect material misstatements due to fraud.

-The outside auditor also must inquire of the audit committee or the audit committee chair regarding the committee's views about the risks of fraud, the committee's oversight of the entity's assessment of the risks of fraud, the programs and controls the entity has established to mitigate those risks, and whether the committee has any knowledge of any fraud or suspected fraud.

Required Communications From the Outside Auditor (continued):

Statement on Auditing Standards 109, Understanding the Entity and Its Environment, requires the outside auditor to obtain an understanding of the entity and its environment, including its internal control, to assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. The auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

- The industry, regulatory, and other external factors;
- The nature of the entity;
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements;
- The measurement and review of the entity's financial performance; and
- Internal control, which includes the selection and application of accounting policies.

Required Communications From the Outside Auditor (continued):

Statement on Auditing Standards 109, Understanding the Entity and Its Environment (continued):

With respect to the relevant industry, regulatory and other factors, the outside auditor should obtain an understanding of factors that include, for example, industry conditions, such as the competitive environment, supplier and customer relationships, and technological developments; the regulatory environment encompassing, among other matters, relevant accounting pronouncements, the legal and political environment, and environmental requirements affecting the industry and the entity; and other external factors, such as general economic conditions.

In pertinent part, with respect to the entity, the outside auditor is required to obtain an understanding of the five components of internal control (control environment; risk assessment; information and communication; control activities; and monitoring) sufficient to assess the risk of material misstatement for the purpose of the audit. SAS 109 applies to all audits, and is not limited to an evaluation of internal control under Sarbanes-Oxley §404.

Required Communications From the Outside Auditor (continued):

Statement on Auditing Standards 109, Understanding the Entity and Its Environment (continued):

Regarding “control environment,” the control environment sets the tone of the organization. The outside auditor is required to consider the entity’s processes relating to communication and enforcement of integrity and ethical values; commitment to competence; participation of those charged with governance; management’s philosophy and operating style; organizational structure; assignment of authority and responsibility; and human resource policies and practices.

SAS 109 further provides that the responsibilities of those charged with governance are of considerable importance. This is recognized in codes of practice and other regulations or guidance produced for the benefit of those charged with governance. In understanding the control environment, the auditor should consider such matters as the independence of the directors and their ability to evaluate the actions of management. The auditor also should consider whether there is a group of those charged with governance that understands the entity's business transactions and evaluates whether the financial statements are presented fairly in conformity with generally accepted accounting principles.

Required Communications From the Outside Auditor (continued):

Statement on Auditing Standards 109, Understanding the Entity and Its Environment (continued):

With respect to evaluating the participation of those charged with governance, SAS 109 specifically identifies the following criteria: (1) independence from management, (2) the experience and stature of those charged with governance, (3) the extent of their involvement in and scrutiny of activities, (4) the information that those charged with governance are provided, (5) the degree to which difficult questions are raised and pursued with management, (6) the ability of those charged with governance to evaluate the actions of management, (7) interaction with internal and outside auditors, (8) communications between management and those charged with governance, and (9) the ability of those charged with governance to understand the company's business transactions and evaluate whether financial statements are presented fairly in conformity with generally accepted accounting principles.

Please note that SAS 109 is a detailed pronouncement, which is too detailed to completely summarize in these materials.

Required Communications From the Outside Auditor (continued):

Statement on Auditing Standards 112, Communicating Internal Control Related Matters Identified in an Audit, is applicable for all audits, and is not limited to audits performed for the purpose of Sarbanes-Oxley §404. SAS 112 specifies that:

The outside auditor must communicate in writing to management and the audit committee (and perhaps the board) significant control deficiencies and material weaknesses in controls identified during the audit. The auditor's responsibility to communicate significant deficiencies and material weaknesses exists even if management or those charged with governance decided to accept that degree of risk.

Each of the following is an indicator of a control deficiency that should be regarded as at least a significant deficiency and a strong indicator of a material weakness in internal control:

-Ineffective oversight of the company's financial reporting and internal control by those charged with governance;

-Restatement of previously issued financial statements to reflect the correction of a material misstatement due to error or fraud;

Required Communications From the Outside Auditor (continued):

Statement on Auditing Standards 112, Communicating Internal Control Related Matters Identified in an Audit (continued):

- Identification by the auditor of a material misstatement in the financial statements for the period under audit that was not initially identified by the company's internal control, even if management subsequently corrects the misstatement;
- An ineffective internal audit or risk assessment function for a company for which those functions are important to the monitoring or risk assessment of internal control;
- For complex entities in highly regulated industries, an ineffective regulatory compliance function for which associated violations of laws and regulations could have a material effect on the reliability of financial reporting;
- Identification of fraud of any magnitude on the part of senior management;
- Failure by management or those charged with governance to assess the effect of a significant deficiency, and either correct it or conclude that it will not be corrected; and
- An ineffective control environment.

Required Communications From the Outside Auditor (continued):

Public Company Accounting Oversight Board (PCAOB) Auditing Standard (AS) 5, An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements (replacing AS2), applies to a specific audit of internal control, such as one performed pursuant to Sarbane-Oxley §404, but does not otherwise apply to an audit in general.

AS5 requires the auditor to use a top-down approach to the audit of internal control over financial reporting, beginning at the financial statement level and company-level controls.

Company-level controls include: controls related to the control environment; controls over management overrides; the company's risk assessment process; centralized processing and controls; controls to monitor the results of operations; controls to monitor other controls, including activities of the internal audit function, the audit committee, and its self-assessment program; controls over the period-ending financial reporting process; and policies that address significant business control and risk management practices.

Required Communications From the Outside Auditor (continued):

Public Company Accounting Oversight Board Rule 3526, Communication with the Audit Committee Concerning Independence (replacing Independence Standards Board Standard 1); Rule 3525, Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control Over Financial Reporting; Rule 3523-Tax Services for Persons In Financial Reporting Oversight Roles.

Evaluating outside auditor independence, and whether or not to approve any non-audit services by the outside auditor, can be a detailed and challenging evaluation and decision. You need to read and understand the Rules. See my more detailed papers. Basically, prior to accepting an audit engagement, and at least annually thereafter, the outside auditor must disclose and describe in writing, and discuss with the audit committee all relationships that may reasonably bear on the outside auditor's independence, and affirm in writing that the outside auditor is independent. The rules also apply for the purpose of obtaining the audit committee's pre-approval of any non-audit services that the outside auditor proposes to perform.

Required Communications From the Outside Auditor (continued):

Statement on Auditing Standards 100, Interim Financial Information (i.e., review engagements).

There is very little discussion (basically no discussion) about the value of a review engagement, such as the quarterly review performed by the outside auditor for public companies. In a review engagement the outside auditor performs certain required procedures, that may cause the auditor to become aware of significant information regarding the financial statements. If the outside auditor does become aware of certain information during the course of a review engagement, SAS 100 requires the auditor to communicate that information to management and the audit committee as appropriate.

Additionally, when conducting such a review, the auditor should determine whether any of the matters described in SAS 114 have been identified, and, if so, the auditor should communicate them to the audit committee or be satisfied that those matters have been communicated to the audit committee by management.

For additional information, see my paper, Information That Might Be Provided By Unaudited (Reviewed and Complied) Financial Statements.

The Internal Audit Function:

It is a common theme throughout these materials that the audit committee must as a matter of fact and prudence obtain information from other people, and also must depend on other people to help the audit committee members satisfy their responsibilities. Internal audit can be a primary asset in assisting the committee in that regard.

Management is responsible for designing and implementing internal controls. Internal audit provides assurance to management and the audit committee that internal controls are effective and working as intended. Internal audit activity is led by the chief audit executive ("CAE"). Broadly speaking, internal audit evaluates risk exposures relating to the organization's governance, operations and information systems, in relation to the effectiveness and efficiency of operations; the reliability and integrity of financial and operational information; the safeguarding of assets; and compliance with laws, regulations, and contracts.

Although only the NYSE rules require that listed companies have an internal audit function, it is common for NASDAQ listed companies to have an internal audit function and to address the issue of that function in the audit committee charter.

The Internal Audit Function (continued):

NYSE Listed Company Manual §303A.07 requires that each listed company must have an internal audit function, and that the audit committee's charter must in part address that the committee will assist the board's oversight of the performance of the company's internal audit function; that the audit committee shall meet separately and periodically with the internal auditors; and that the audit committee shall report regularly to the board of directors, and review with the full board any issues that arise with respect to the quality or integrity of the company's financial statements, the company's compliance with legal or regulatory requirements, the performance and independence of the company's outside auditor, and the performance of the internal audit function.

Pursuant to Statement on Auditing Standards 112, an ineffective internal audit or risk assessment function for a company for which those functions are important to the monitoring or risk assessment component of internal control should be regarded as at least a significant deficiency and a strong indicator of a material weakness in internal control. PCAOB Auditing Standard No. 5 directs that the outside auditor should use a top-down approach to the audit of internal control over financial reporting, beginning at the financial statement level and company-level controls, and that company-level controls in part include controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs.

The Compliance and Ethics Function:

NYSE Listed Company Manual §303A.07, Additional Requirements of the Audit Committee, in part states that the audit committee must have a written charter that addresses the purpose of the audit committee which in part must be to report regularly to the board of directors, and review with the full board any issues that arise with respect to the company's compliance with legal or regulatory requirements.

Section 303A.07 is probably too broadly worded with respect to audit committee responsibilities relating to legal and regulatory requirements. For example, we have already seen that the audit committee probably at most has an obligation to oversee compliance with the potential violations of laws and potential fraud that may have a direct material effect on the financial statements and related reporting, and other indirect related matters that come to the audit committee's attention.

We have also already discussed that the audit committee must by its very nature obtain information from other people to help the committee to satisfy its duties and responsibilities. No authority requires the audit committee to oversee the activities of the compliance and ethics function, if in fact the entity has such a function. However, such a function can help the audit committee to satisfy its duties and responsibilities.

The Compliance and Ethics Function:

The compliance and ethics function is responsible to prevent and detect certain civil and criminal wrongdoing, and unethical and non-compliant behavior by the entity's officers, employees, board members and other related people, and otherwise promote an organizational culture that encourages ethical conduct and a commitment to compliance with laws, regulations and the standards. It is involved in the design, development, implementation, monitoring, enforcement and management of governance, risk and control processes relating to compliance with laws and ethics. Typically the compliance and ethics function is also concerned with the entity's processes to comply with the U.S. Federal Sentencing Guideline requirements for an effective compliance program. The guidelines specify that to have an effective compliance and ethics program an entity shall:

- Exercise due diligence to prevent and detect criminal conduct;
- Promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law; and
- Design, implement, and enforce its compliance and ethics program so that it is generally effective in preventing and detecting criminal conduct.

The Compliance and Ethics Function (continued):

Organizations, such as corporations, can be guilty of civil and criminal misconduct. An organization's punishment for felonies and certain misdemeanors is governed by the U.S. Federal Sentencing Guidelines. Organizations can be fined, sentenced to probation, ordered to make restitution and issue public notices of conviction, and exposed to forfeiture statutes. Some common offenses committed by organizations are fraud, environmental waste, tax offenses, antitrust offenses, and food and drug violations. An organization can be found criminally liable when an employee of the organization commits an act within the apparent scope of employment, even if the employee acted contrary to company policy or instructions. An organization also can be held criminally liable for any of its employees' illegal actions even if it made reasonable efforts to prevent the wrongdoing. In enacting the sentencing guidelines, the U.S. Sentencing Commission has attempted to lessen some of the harshest aspects of potential liability for organizations that can demonstrate that they have enacted appropriate and effective preventative, deterrent and reporting compliance programs.

It is not uncommon for the compliance and ethics function to also interact or be involved with the internal audit function. To the extent that the audit committee may be responsible for entity compliance with laws and ethics, the compliance and ethics function can help the audit committee to satisfy its duties and responsibilities.

Risk Management:

The risk management topic is too broad to cover in these materials. I mention risk management for three reasons: current proposed legislation would require each public company board to have a risk management committee, studies have shown that at the board level risk management oversight is most often assigned to the audit committee, and NYSE Listed Company Manual §303A.07 requires the audit committee's charter to address the committee's duties and responsibilities including the responsibility to discuss policies with respect to risk assessment and risk management. Commentary to §303A.07 states that the CEO and senior management should assess and manage the company's exposure to risk, but that the audit committee must discuss guidelines and policies to govern the process by which this is done—that the audit committee should discuss the company's major financial risk exposures and the steps management has taken to monitor and control exposures—and that if a company manages and assesses its risk through mechanisms other than the audit committee, the processes that the company has in place should be reviewed in a general manner by the audit committee, but those mechanisms need not be replaced by the audit committee. Risk management is a dynamic and developing topic in governance. For additional information you can refer to my separate paper discussing internal control, compliance and ethics, risk management, the Federal Sentencing Guidelines, the Foreign Corrupt Practices Act and related topics. You can also refer to the COSO website, <http://www.coso.org>.

The Audit Committee Charter:

The audit committee charter is significantly particular to each audit committee, board and company. Public companies are required by law to have an audit committee charter. For public companies, the charter should cover the committee member qualifications and the committee functions and responsibilities required by securities statute, rule or regulation, and by the exchange on which the company's stock is listed. NYSE and NASDAQ audit committee requirements are similar, but not identical. It is difficult to develop a generic charter. It is important to keep in mind that various courts have looked at the committee charter to determine the audit committee's duties and responsibilities, and to hold the audit committee to those representations. Audit committee members and their counsel need to give appropriate consideration to ensure that the charter meets legal requirements, and that the committee members understand and will undertake to satisfy the duties and responsibilities that are listed.

The charter also is helpful to clarify for all interested persons the composition, duties and responsibilities of the audit committee, and, at least indirectly, the duties and responsibilities that are not expected. Thus, although not legally required, it is recommended that the audit committees of private companies and nonprofit entities also consider adopting charters.

Annual Audit Committee Evaluation:

NYSE Listed Company Manual §303A.07 requires the audit committee of each company listed on the Exchange to conduct an annual performance evaluation. Annual self-evaluation should be suggested for all public company audit committees, and should be considered by audit committees of reasonably large nonprofit entities and private companies.

No specific evaluation process or format is required. Although not required, there can be advantages to having a facilitator conduct an interactive evaluation approach. For additional discussion, see my separate paper discussing the annual evaluation process.

Also consider whether the evaluation will be conducted under the umbrella of legal counsel for possible confidentiality. I mention this only as a potential issue. The fact is that board and committee members should always consider that their activities might be discoverable on legal grounds, and that they may want to voluntarily make their activities known so as to demonstrate diligent business judgment, or to negate allegations improper intent, recklessness, or intentional wrongdoing, also known as "scienter" in the context of securities litigation.

The Agenda and Meeting Processes, Decision Making Processes, and Documentation:

Agenda and Meeting Processes. Yes the audit committee should consider processes for the preparation of meeting agenda items, with input from committee members, and dissemination of the written meeting agenda to members sufficiently prior to meetings; processes for determining who will attend committee meetings, and executive sessions; processes for determining the dates and times of meetings; pre-meeting processes for informing non-committee attendees about agenda items that are pertinent to them; documenting committee activities; and process for informing the board of committee activities. See <http://davidtate.us> for additional discussions on these topics.

Decision Making Processes. No particular decision making process is required—in fact an almost unlimited number of different processes could be acceptable. Audit committee members may wish to consider a general decision making process. For example, a simple approach might be: identify and outline the issues to be placed on the committee's agenda; investigate the issues; analyze what information is needed to evaluate the issues and who will provide that information; analyze what consultation or expertise, if any, is needed; obtain the additional information, consultation and/or expertise; discuss the issues; determine whether additional information, etc. is needed and if so, obtain it; discuss and deliberate regarding the issues; document committee proceedings; report to the board or other pertinent people, and follow-up regarding next steps and future decision making, if any, relevant to the issues.

The Agenda and Meeting Processes, Decision Making Processes and Documentation (continued):

Documentation. Yes, the audit committee should consider appropriately documenting committee meetings and actions for diligence and business judgment purposes, to aid with future actions and follow-up, and to better avoid possible later confusion regarding actions taken and decisions made. The committee does need to consider which activities and discussions are sufficiently important to document. Although there should be reasonable concern that there could be an attempt by an outside entity to use the documentation as a road map to wrongdoing, a lack of documentation also could be viewed negatively, particularly if the standard of practice is to document activities. In a couple of high profile cases, courts have held that even investigation reports prepared through legal counsel can be discoverable in certain situations. Consideration also should be given to the U.S. Department of Justice so called McNulty Memorandum discussing federal prosecution of business organizations.

Hypothetical Situations and Interactive Discussion:

Discussion Presented In Seminar

Lessons Learned From the Current Environment and Financial Crisis—New
Developments and Looking Ahead:

Discussion Presented In Seminar

Yes, Getting the Job Done Diligently and Safely—a Process Proposal:

So . . . what does all this mean? It means that an audit committee member should consider having in mind the components of a process for going about accomplishing his or her duties and tasks as an audit committee member. There is no one single process that is acceptable, and there is no one single process that would apply in all circumstances. Having in mind the components of a process may simply be helpful to accomplishing the tasks of the committee and its members. For example, the following are elements or components of one possible process that an audit committee member may wish to consider:

1. The audit committee member's qualifications to serve as a member of the committee including independence, and pertinent experience and current knowledge, and the ability and resources to obtain current knowledge relative to audit committee duties and standards of care, accounting, auditing, internal controls, the entity and its industry, and related topics.
2. Appropriate demeanor and integrity to serve as a committee member.
3. A willingness and ability to lead, make informed decisions, and communicate.

Yes, Getting the Job Done Diligently and Safely—a Process Proposal (continued):

4. The availability of time to serve as a committee and board member, and a commitment to the entity and its shareholders.
5. Appropriate committee agenda and meeting processes.
6. Appropriate decision making, documentation and reporting processes, and diligent attention to the tasks of the committee.
7. The charter and a mutual understanding of the committee's responsibilities and duties between all relevant people and groups including the board.
8. Appropriate and satisfactory interaction and understanding between the committee members, and between the committee and other people with whom the committee members must rely upon, obtain information from, and interact.
9. And, appropriate support and cooperation from the relevant corporate officers, corporate functions, and the board.