

# **TATE'S EXCELLENT AUDIT COMMITTEE GUIDE**

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## **TABLE OF CONTENTS BY TOPIC AREA**

### **I. INTRODUCTION**

### **II. THE BUSINESS JUDGMENT RULE**

### **III. SELECT STANDARD OF CARE CASES**

### **IV. COMMITTEE COMPOSITION AND MEMBER QUALIFICATIONS**

#### **A. Federal Statutes and Regulations, and Related Rules**

1. Public Company Audit Committee Member Independence
2. Disclosure of Audit Committee Financial Expert

#### **B. Stock Exchange (SRO) Rules**

1. NYSE Listed Company Manual
  - a. Audit Committee Required
  - b. Audit Committee Composition and Other Requirements
  - c. Independence Tests
2. NASDAQ Stock Market Rules
  - a. Audit Committee Composition
  - b. Independent Director Defined

## **V. COMMITTEE FUNCTIONS AND RESPONSIBILITIES**

### **A. Federal Statutes and Regulations, and Related Rules**

1. Public Company Audit Committee Responsibilities
2. Corporate Responsibility for Financial Reports
3. Improper Influence on the Conduct of Audits
4. Management Assessment of Internal Controls
5. Code of Ethics for Senior Financial Officers
6. Real-Time Issuer Disclosures
7. Whistleblower and Anti-Retaliation Provisions
  - a. Protection for Employees of Publicly Traded Companies
  - b. Retaliation Against Informants
8. Auditor Auditing and Nonaudit Services, and Preapproval of Services
  - a. Services Outside the Scope of Practice of Auditors
  - b. Preapproval Requirements
  - c. Audit Partner Rotation
  - d. Auditor Report to Audit Committees
  - e. Conflicts of Interest
  - f. Unlawful Acts Discovered During Audit

### **B. Stock Exchange (SRO) Rules**

1. NYSE Listed Company Manual
  - a. Audit Committee Additional Requirements
  - b. Executive Sessions of Non-Management Directors
2. NASDAQ Stock Market Rules
  - a. Audit Committee Charter
  - b. Audit Committee Responsibilities and Authority
  - c. Independent Directors and Executive Sessions
  - d. Conflicts of Interest
  - e. Code of Conduct

## **VI. AUDITS, REVIEWS AND COMPILATIONS**

### **A. Audits**

1. Overview
2. SAS 109 – understanding the entity and its environment and assessing risks of material misstatement
3. SAS 114 – auditor’s communications with audit committees and those charged with governance
4. SAS 115 – communicating internal control matters identified in an audit, is applicable for all audits and is not limited to audits performed for the purpose of Sarbanes-Oxley §404
5. SAS 122 – AU-C Section 240 Consideration of Fraud in a Financial Statement Audit
6. PCAOB AS no. 5 – An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements
7. PCAOB AS no. 16 – Communications with Audit Committees

### **B. Reviews**

### **C. Compilations**

## **VII. AUDIT COMMITTEE EVALUATION OF THE EXTERNAL AUDITOR**

## **VIII. INTERNAL CONTROLS**

### **A. COSO 2013**

### **B. Fraud – Example Means and Prevention**

### **C. Select Accounting Transaction Internal Control Safeguards**

## **IX. INTERNAL AUDIT**

## **X. RISK MANAGEMENT**

## **XI. AUDIT COMMITTEE AGENDA, APPROACH AND DOCUMENTATION**

## **XII. AUDIT COMMITTEE AND BOARD SELF-EVALUATION**

## **XIII. NONPROFIT BOARDS AND AUDIT COMMITTEES (CALIFORNIA)**

## **XIV. INVESTIGATIONS; CONFLICTS OF INTEREST; SPECIAL COMMITTEES**

## **XV. ADDITIONAL COMPLIANCE MATERIALS; FCPA; ETC.**

## **XVI. POSSIBLE ADDITIONAL TOPICS/ISSUES – JUST A NOTE FOR REFERENCE**

## MATERIALS

### I. INTRODUCTION

This guide covers public company, nonprofit and private company audit committee functions and responsibilities; however, audit committee functions and responsibilities differ between those three entity categories – thus, some of the materials in this guide will apply to public company audit committees, whereas other materials will apply to audit committees of nonprofit or private company entities.. Audit committees and their members are regulated or impacted by numerous and increasing numbers of statutes, cases, regulations, rules and pronouncements. Some audit committee responsibilities are mandatory, whereas other committee and committee member functions and responsibilities are subject to standards of “reasonableness” or are discretionary depending on the circumstances. Although an increasing number of the functions and responsibilities are specified by statute, regulation or rule, satisfaction of an audit committee member’s standard of care remains significantly dependent on due diligence and prudent judgment. Audit committee functions and responsibilities continue to change and increase. These materials are arranged by major topic areas. A statute, regulation or rule may be discussed in multiple areas where it applies to more than one topic.

These materials will be a continual work in progress as new developments tend to occur weekly. Previously my audit committee materials were presented in a compendium format through *Audit Committee Functions and Responsibilities*, Chapter 5A for the California Continuing Education of the Bar publication, *Advising and Defending Corporate Directors and Officers* (October 2007), and prior to that through *Accounting and Its Legal Implications, A Guide for Managers, Business Owners, and Entrepreneurs* (Irwin Professional Publishing, Business One 1994), and I discuss these topics and new developments in numerous papers and blog posts (see <http://directorofficernews.com>).

I encourage you to tell other people about these materials for their use – this endeavor is really only worthwhile if it is useful and people read it.

The manner in which I am preparing these materials and making them available to you is new and different for me. First, as I have stated, these materials are a continual work in progress as new developments occur very regularly. Second, for some areas I have included links to substantive materials that are located in other areas on the internet. Third, for some of the materials I have included the language of the relevant statute, regulation or rule – although that can make the reading more difficult, as a lawyer for many years I have learned to appreciate having the actual source document language in some circumstances instead of a paraphrase of that important language.

Thank you. Please do go ahead and use and share these materials with other people who would be interested. Dave Tate, Esq. (email: [davetateesq@gmail.com](mailto:davetateesq@gmail.com))

The obligatory disclaimer: These materials do not provide legal, accounting or other professional advice, and are not a solicitation for work. These materials do not apply to any particular person, entity, event, transaction or situation. As these materials are only a summary of technical and

detailed subject matters, and are updated and changed periodically, it should be clear that if you have questions or issues about a particular specific situation, you need to seek your own legal, accounting or other professional assistance, and you absolutely should not rely on these summary materials to guide your situation or your actions.

[Hyperlink Back to Main Table of Contents](#)

## **II. THE BUSINESS JUDGMENT RULE**

The business judgment rule provides a director with a defense to personal liability, holding that as a general principle of law, a director, including a director who serves as a member of a board committee, who satisfies the business judgment rule has satisfied his or her duties. Thus, the business judgment rule provides one standard of care, although other standards may very well also apply to specific tasks and responsibilities. I have started with the business judgment rule because it provides a very good overall approach for directors and audit committee members to follow, although lacking in specific detail. In some states the business judgment rule is codified by statute while in other states the rule is established by case law (see, i.e., Cal. Corp. Code §309 for California corporations, Del. Gen. Corp. Law §141 for Delaware corporations, in addition to relevant case law). The rule also applies to directors as board committee members.

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, conflict 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, a director must necessarily obtain information from and rely upon other people. The director is not involved in the day-to-day operations of the business. The director provides an oversight function. Pursuant to the business judgment rule, a director 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.

Stated differently the following is from my two page summary of the business judgment rule written in more conversational English.

## 2-PAGE BOARD & DIRECTOR OVERSIGHT GUIDELINES

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<http://directorofficernews.com>

This paper is applicable for all entities – public companies, private companies and organizations, nonprofits and governmental entities – although depending on the entity type or situation, sometimes the terminology or context might be different. These guidelines will help the prudent director accomplish his or her responsibilities. This paper is comprised of two primary sections: Overall Guidelines and Oversight Areas. Some of these guidelines are simply prudent business judgment, which might also be a legal defense to allegations of director wrongdoing. Some of the guidelines are required by law.

The following 10 board and director Overall Guidelines are grouped into two areas: general and specific. I have intentionally avoided a checklist approach. The 10 Overall Guidelines are primarily based on the business judgment rule and related statutes, regulations and rules. See also the Oversight Areas topic that follows.

### OVERALL GUIDELINES

There are 4 general guidelines, not in any particular order:

1. Act with integrity, honesty and professionalism, and without self-dealing, self-interest or conflict of interest, and require that of others.
2. Act in the manner that you believe is best for the organization, and require that of others, even if at times it isn't comfortable for you to do so.
3. Be heard and actively involved, speak up, and be counted, with the appropriate "working together" demeanor.
4. Be a leader, by example.

The remaining guidelines, numbers 5 through 10 are more specific. Again not in any particular order:

5. Know your responsibilities, and make sure the other people are in agreement about your responsibilities. Some people might refer to this as having a charter, but I believe this guideline requires more detail and understanding than a typical charter. You should also be analyzing and

revising or updating your board and committee charters and responsibilities. Right now, for example, especially for activities having to do with risk management, and cybersecurity.

6. Acquire the information that you need so that you can accomplish your responsibilities, by exercising active, timely and inquiring diligence and follow-up, talking with people and acquiring information.

7. Timely possess and acquire the knowledge and education that you need so that you know your responsibilities and are prepared to perform your responsibilities, address the issues, and act with prudence.

8. Rely on other people including information provided by other people only if (1) you believe those people are reliable and competent in the areas that they are addressing, (2) your reliance is in good faith, after reasonable inquiry as warranted by the circumstances, and (3) you do not have knowledge that would cause reliance to be unwarranted.

And as a sub-set of number 8, ask the people who you are relying on for information the following question, “What else do you know that I should also know?”

9. Make diligent informed decisions in keeping with these guidelines, including the difficult decisions.

10. And for number 10 I have included a suggestion. Take time to reflect on the organization, the board and the board committees, important issues and topics, and how things are going, what needs to happen, and things about which you have questions. Then, communicate the issues, topics and actions that you believe need to be addressed, in keeping with the organization’s mission and your responsibilities.

Number 10 also relates to board and committee agenda setting. To whom do you communicate proposed agenda issues and topics? Are your issues and topics given due consideration?

Of course, accomplishing director responsibilities is also a function of the board’s overall governance, operations, expertise, functioning and atmosphere of professionalism. And remember the annual or more often evaluation of the board and its committees.

### OVERSIGHT AREAS

Broadly speaking a director’s responsibility is to act as a member of the board which is responsible for oversight (not day-to-day operation) of the organization’s significant activities, processes and actions in the following areas, not in any particular order:

- Strategy – short, mid- and long-term (mission, product/service, operational, R&D, innovation, development, technology, branding, reputation, value creation, profitability and sustainability);
  - Governance and tone-at-the-top, including management and the board and its committees;
    - Risk and uncertainty management, including risk response;
    - Compliance with laws, regulations, rules and other requirements;
    - Accounting and financial reporting;

- CEO and other executive/senior talent and succession;
  - Executive compensation;
- M&A including sales, and significant/strategic collaborations, affiliations and relationships;
  - Investigations as appropriate and if needed;
  - Investor and stakeholder relations;
- Executive officer, director and insider conflicts of interest and use of organization assets;
  - Board composition and nominations; and
- Aspects of information/data security and privacy, HR, personal safety, and catastrophic events.

Of course as you drill down each organization will have specific board oversight sub-areas or topics that are industry or entity specific. The specific sub-areas could be extensive. Again, for the purpose of this discussion I have intentionally avoided a checklist approach.

Oversight responsibilities also change over time. Obviously new and specific issues do become relevant as facts, circumstances and current events occur or change.

And for many areas – for example audit committees, executive compensation, investigations, and risk or uncertainty management – there will be additional specific responsibility requirements.

\* \* \* \* \*

Stated still differently, but not in the strict legal sense, at the end of the day, the performance of an audit committee member's oversight responsibilities requires:

1. Audit committee member understanding, qualifications, integrity, competency, and freedom from conflict and self-interest;
2. Committee agenda;
3. Timely and active diligence;
4. Putting in the time;
5. Reasonable reliance on competent other people (the CEO, the CFO, internal audit if there is one, the external auditor, culture, reputation and tone at the top, the accounting and financial reporting functions and professionals, legal counsel and others);
6. Sufficiency of information;
7. Deliberative decision making; and
8. Anticipation and thinking ahead.

[Hyperlink Back to Main Table of Contents](#)



### **III. SELECT STANDARD OF CARE CASES**

Historically few court cases have specifically discussed audit committee duties and liability; however, more cases have discussed due diligence or business judgment rule principles as applied or discussed with respect to the actions or inactions of corporate directors, some of whom have been independent directors or members of the audit committee.

The following is a representative sample of cases. Moving forward I will be supplementing this section with more recent representative cases and SEC proceedings. It isn't my intention to discuss all cases – many cases contain similar issues – the intent is to provide you with an overall understanding of the case landscape.

More recently there have been a number of cases involving foreign subsidiary, affiliate and supplier bribery and internal control failures and the Foreign Corrupt Practices Act.

Viewed broadly these cases represent accounting, auditing, internal control or oversight failures some of which might have been avoidable; however, we do need to recognize that an audit committee member serves an oversight responsibility and is not involved in the day-to-day transactions. Additionally, even in the best of possible situations it is possible that fraud, bribery or some other error or impropriety might not be prevented or detected.

- *In re Digi Int'l, Inc. Secs. Litig.* (8th Cir 2001) 14 Fed Appx 714, 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.
- *Hanson Trust PLC v ML SCM Acquisition, Inc.* (2d Cir 1986) 781 F2d 264, holding that when a director has actual knowledge of a problem, he or she must initiate discussions rather than wait for management to do so, and that a director must become reasonably familiar with an opinion, report, or other source of advice before it can be relied on.
- *In re Hollinger Int'l, Inc. Secs. Litig.* (ND Ill 2006) 2006 US Dist Lexis 47173, holding that while audit committee members as outside directors 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. Secs. Litig.* (SD NY 2005) 2005 US Dist Lexis 4193, in part holding that whereas audited financial statements are considered to be based on the authority of an expert (the independent auditor), unaudited (reviewed) financial statements are not considered to be based on the authority of an 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 Spiegel, Inc. Secs. Litig.* (ND Ill 2004) 382 F Supp 2d 989, 1019, holding in part that audit committee members had a duty to ensure the accuracy and fairness of the company's

disclosures in SEC filings. See also, *In re Cabletron Sys., Inc.* (1st Cir 2002) 311 F3d 11, and *Howard v Everex Sys., Inc.* (9th Cir 2000) 228 F3d 1057, holding in part that audit committee members are responsible for the contents of the corporate documents that they sign, such as Form 10-K and Form 10-Q.

- *Wafra Leasing Corp. 1999-A-1 v Prime Capital Corp.* (ND Ill 2004) 2004 US Dist Lexis 17468, \*27, in which the court held that a question of fact existed regarding audit committee member control, noting the company's proxy statement that the function of the audit committee was establishing and maintaining communications with the Company's internal and independent accountants, reviewing the methods used and examinations made by the auditors in connection with the Company's published financial statements and reviewing with the auditors the Company's financial and operating controls.
- *In re Dynege, Inc. Secs. Litig.* (SD Tex 2004) 339 F Supp 2d 804, holding in pertinent part that the board's reliance on the statements by the company's managers alone was not sufficient and did not entitle the board members to prevail based on due diligence.
- *In re Hayes Lemmerz Int'l, Inc. Equity Secs. Litig.* (ED Mich 2003) 271 F Supp 2d 1007, in which the court in part allowed the action against the independent audit committee members to proceed, based on relatively general allegations about the responsibilities of the audit committee as 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, financial statements, and internal controls.
- *In re Lernout & Hauspie Secs. Litig.* (D Mass 2002) 286 BR 33, in which the court in part denied the motion of the audit committee members to dismiss the complaint because they had signed the company's SEC filings, and they had the ability to retain accounting and legal advisors to investigate the alleged accounting improprieties; had the power to force the resignation of the senior company officers; had access to the company's financial information; and had been made aware of the accounting problems by meetings with the company's outside auditor and access to the company's financial statements. The court also noted evidence that the audit committee was aware that the company had failed to implement a system of internal audit controls, failed to timely hire an internal auditor, continued to sign off on the financial statements despite the lack of internal controls and various red flags, and allowed the company to issue financial information press releases without prior approval of the audit committee.
- *Escott v. BarChris Constr. Corp.* (SD NY 1968) 283 F Supp 643, holding that the director failed to read the prospectus carefully or investigate its accuracy, and improperly relied on the reputation of the outside auditors and the cursory unsubstantiated assurances of the company's officers. The director was held to the same due diligence standard even though he had only taken office on the eve of the financing transaction.
- *In re Chancellor Corp.* (April 24, 2003) SEC Litigation Release No. 18104, SEC Accounting and Auditing Enforcement Release No. 1763 (April 24, 2003), in which the outside director and audit committee chair were charged 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.

- *In re W.R. Grace & Co.* (Sept. 30, 1997) SEC Release Nos. 34-39156 and 34-39157, in which it was alleged that the director's reliance on the company's standard disclosure review process and on counsel's review of documents was insufficient.
- *In re Nat'l Tel. Co., Inc.* (Jan. 16, 1978) SEC Release No. 34-14380, in which the SEC criticized outside directors for allegedly permitting management to report high earnings and forecast positive projections during a period in which the company was in seriously poor financial condition, and for failing to prevent false disclosures or to require management to disseminate timely corrective disclosures.
- *Report in Matter of Stirling Homex Corp.* (July 2, 1975) SEC Release No. 34-11516, in which the SEC alleged that the outside directors did not acquire sufficient understanding of the company's accounting practices (and unreasonably relied on the acceptance of those practices by the independent accountant), that they were unable to detect problems because they were uninformed about the corporation's business and operations, and that they failed to suspect wrongdoing by management.
- *In re Caremark Int'l, Inc. Derivative Litig.* (Del Ch 1996) 698 A2d 959, in part holding that under the business judgment rule, there is no ground for director liability if the process used by the director in arriving at his or her decision was rational and employed in good faith to advance the company's interests; a director satisfies his or her duty when he or she exercises a good faith effort to be informed and to exercise appropriate judgment; directors do not satisfy their duty to monitor the company's matters if they do not assure themselves that information and reporting systems exist that are designed to provide management and the board with timely and accurate information sufficient to allow them to reach informed decisions; and the directors satisfied their duties to monitor the company's activities by establishing an oversight committee, even though some illegal activities had occurred.
- *Smith v Van Gorkom* (Del 1985) 488 A2d 858, holding a director liable for approving a proposal for sale of the company without adequate investigation.

[Hyperlink Back to Main Table of Contents](#)

#### IV. COMMITTEE COMPOSITION AND MEMBER QUALIFICATIONS

##### A. Federal Statutes and Regulations, and Related Rules

##### 1. Public Company Audit Member Independence

Relating to public company audit committee member independence 15 USC §78j-1(m)(3) requires as follows:

##### (3) Independence

##### (A) In general

Each member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent.

(B) Criteria

In order to be considered to be independent for purposes of this paragraph, a member of an audit committee of an issuer may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee—

(i) accept any consulting, advisory, or other compensatory fee from the issuer; or

(ii) be an affiliated person of the issuer or any subsidiary thereof.

(C) Exemption authority

The Commission may exempt from the requirements of subparagraph (B) a particular relationship with respect to audit committee members, as the Commission determines appropriate in light of the circumstances.

Relating to public company audit committee member independence 17 CFR §240.10A-3 requires as follows:

§240.10A-3 Listing standards relating to audit committees.

(a) Pursuant to section 10A(m) of the Act (15 U.S.C. 78j-1(m)) and section 3 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7202):

(1) National securities exchanges. The rules of each national securities exchange registered pursuant to section 6 of the Act (15 U.S.C. 78f) must, in accordance with the provisions of this section, prohibit the initial or continued listing of any security of an issuer that is not in compliance with the requirements of any portion of paragraph (b) or (c) of this section.

(2) National securities associations. The rules of each national securities association registered pursuant to section 15A of the Act (15 U.S.C. 78o-3) must, in accordance with the provisions of this section, prohibit the initial or continued listing in an automated inter-dealer quotation system of any security of an issuer that is not in compliance with the requirements of any portion of paragraph (b) or (c) of this section.

(3) Opportunity to cure defects. The rules required by paragraphs (a)(1) and (a)(2) of this section must provide for appropriate procedures for a listed issuer to have an opportunity to cure any defects that would be the basis for a prohibition under paragraph (a) of this section, before the imposition of such prohibition. Such rules also may provide that if a member of an audit committee ceases to be independent in accordance with the requirements of this section for reasons outside the member's reasonable control, that person, with notice by the issuer to the applicable national securities exchange or national securities association, may remain an audit committee member of the listed issuer until the earlier of the next annual shareholders meeting of the listed issuer or one year from the occurrence of the event that caused the member to be no longer independent.

(4) Notification of noncompliance. The rules required by paragraphs (a)(1) and (a)(2) of this section must include a requirement that a listed issuer must notify the applicable national securities exchange or national securities association promptly after an executive officer of the listed issuer becomes aware of any material noncompliance by the listed issuer with the requirements of this section.

(b) Required standards—(1) Independence. (i) Each member of the audit committee must be a member of the board of directors of the listed issuer, and must otherwise be independent; provided that, where a listed issuer is one of two dual holding companies, those companies may designate one audit committee for both companies so long as each member of the audit committee is a member of the board of directors of at least one of such dual holding companies.

(ii) Independence requirements for non-investment company issuers. In order to be considered to be independent for purposes of this paragraph (b)(1), a member of an audit committee of a listed issuer that is not an investment company may not, other than in his or her capacity as a member of the audit committee, the board of directors, 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.

(iii) Independence requirements for investment company issuers. In order to be considered to be independent for purposes of this paragraph (b)(1), a member of an audit committee of a listed issuer that is an investment company may not, other than in his or her capacity as a member of the audit committee, the board of directors, 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 “interested person” of the issuer as defined in section 2(a)(19) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(19)).

(iv) Exemptions from the independence requirements. (A) For an issuer listing securities pursuant to a registration statement under section 12 of the Act (15 U.S.C. 78l), or for an issuer that has a registration statement under the Securities Act of 1933 (15 U.S.C. 77a et seq.) covering an initial public offering of securities to be listed by the issuer, where in each case the listed issuer was not, immediately prior to the effective date of such registration statement, required to file reports with the Commission pursuant to section 13(a) or 15(d) of the Act (15 U.S.C. 78m(a) or 78o(d)):

(1) All but one of the members of the listed issuer's audit committee may be exempt from the independence requirements of paragraph (b)(1)(ii) of this section for 90 days from the date of effectiveness of such registration statement; and

(2) A minority of the members of the listed issuer's audit committee may be exempt from the independence requirements of paragraph (b)(1)(ii) of this section for one year from the date of effectiveness of such registration statement.

(B) An audit committee member that sits on the board of directors of a listed issuer and an affiliate of the listed issuer is exempt from the requirements of paragraph (b)(1)(ii)(B) of this section if the member, except for being a director on each such board of directors, otherwise meets the independence requirements of paragraph (b)(1)(ii) of this section for each such entity, including the receipt of only ordinary-course compensation for serving as a member of the board of directors, audit committee or any other board committee of each such entity.

(C) An employee of a foreign private issuer who is not an executive officer of the foreign private issuer is exempt from the requirements of paragraph (b)(1)(ii) of this section if the employee is elected or named to the board of directors or audit committee of the foreign private issuer pursuant to the issuer's governing law or documents, an employee collective bargaining or similar agreement or other home country legal or listing requirements.

(D) An audit committee member of a foreign private issuer may be exempt from the requirements of paragraph (b)(1)(ii)(B) of this section if that member meets the following requirements:

(1) The member is an affiliate of the foreign private issuer or a representative of such an affiliate;

(2) The member has only observer status on, and is not a voting member or the chair of, the audit committee; and

(3) Neither the member nor the affiliate is an executive officer of the foreign private issuer.

(E) An audit committee member of a foreign private issuer may be exempt from the requirements of paragraph (b)(1)(ii)(B) of this section if that member meets the following requirements:

(1) The member is a representative or designee of a foreign government or foreign governmental entity that is an affiliate of the foreign private issuer; and

(2) The member is not an executive officer of the foreign private issuer.

(F) In addition to paragraphs (b)(1)(iv)(A) through (E) of this section, the Commission may exempt from the requirements of paragraphs (b)(1)(ii) or (b)(1)(iii) of this section a particular relationship with respect to audit committee members, as the Commission determines appropriate in light of the circumstances.

(c) General exemptions. (1) At any time when an issuer has a class of securities that is listed on a national securities exchange or national securities association subject to the requirements of this section, the listing of other classes of securities of the listed issuer on a national securities exchange or national securities association is not subject to the requirements of this section.

(2) At any time when an issuer has a class of common equity securities (or similar securities) that is listed on a national securities exchange or national securities association subject to the requirements of this section, the listing of classes of securities of a direct or indirect consolidated subsidiary or an at least 50% beneficially owned subsidiary of the issuer (except classes of equity securities, other than non-convertible, non-participating preferred securities, of such subsidiary) is not subject to the requirements of this section.

(3) The listing of securities of a foreign private issuer is not subject to the requirements of paragraphs (b)(1) through (b)(5) of this section if the foreign private issuer meets the following requirements:

(i) The foreign private issuer has a board of auditors (or similar body), or has statutory auditors, established and selected pursuant to home country legal or listing provisions expressly requiring or permitting such a board or similar body;

(ii) The board or body, or statutory auditors is required under home country legal or listing requirements to be either:

(A) Separate from the board of directors; or

(B) Composed of one or more members of the board of directors and one or more members that are not also members of the board of directors;

(iii) The board or body, or statutory auditors, are not elected by management of such issuer and no executive officer of the foreign private issuer is a member of such board or body, or statutory auditors;

(iv) Home country legal or listing provisions set forth or provide for standards for the independence of such board or body, or statutory auditors, from the foreign private issuer or the management of such issuer;

(v) Such board or body, or statutory auditors, in accordance with any applicable home country legal or listing requirements or the issuer's governing documents, are responsible, to the extent permitted by law, for the appointment, retention and oversight of the work of any registered public accounting firm engaged (including, to the extent permitted by law, the resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the issuer; and

(vi) The audit committee requirements of paragraphs (b)(3), (b)(4) and (b)(5) of this section apply to such board or body, or statutory auditors, to the extent permitted by law.

(4) The listing of a security futures product cleared by a clearing agency that is registered pursuant to section 17A of the Act (15 U.S.C. 78q-1) or that is exempt from the registration requirements of section 17A pursuant to paragraph (b)(7)(A) of such section is not subject to the requirements of this section.

(5) The listing of a standardized option, as defined in §240.9b-1(a)(4), issued by a clearing agency that is registered pursuant to section 17A of the Act (15 U.S.C. 78q-1) is not subject to the requirements of this section.

(6) The listing of securities of the following listed issuers are not subject to the requirements of this section:

- (i) Asset-Backed Issuers (as defined in §229.1101 of this chapter);
- (ii) Unit investment trusts (as defined in 15 U.S.C. §80a-4(2)); and
- (iii) Foreign governments (as defined in §240.3b-4(a)).

(7) The listing of securities of a listed issuer is not subject to the requirements of this section if:

(i) The listed issuer, as reflected in the applicable listing application, is organized as a trust or other unincorporated association that does not have a board of directors or persons acting in a similar capacity; and

(ii) The activities of the listed issuer that is described in paragraph (c)(7)(i) of this section are limited to passively owning or holding (as well as administering and distributing amounts in respect of) securities, rights, collateral or other assets on behalf of or for the benefit of the holders of the listed securities.

(d) Disclosure. Any listed issuer availing itself of an exemption from the independence standards contained in paragraph (b)(1)(iv) of this section (except paragraph (b)(1)(iv)(B) of this section), the general exemption contained in paragraph (c)(3) of this section or the last sentence of paragraph (a)(3) of this section, must:

(1) Disclose its reliance on the exemption and its assessment of whether, and if so, how, such reliance would materially adversely affect the ability of the audit committee to act independently and to satisfy the other requirements of this section in any proxy or information statement for a meeting of shareholders at which directors are elected that is filed with the Commission pursuant to the requirements of section 14 of the Act (15 U.S.C. 78n); and

(2) Disclose the information specified in paragraph (d)(1) of this section in, or incorporate such information by reference from such proxy or information statement filed with the Commission into, its annual report filed with the Commission pursuant to the requirements of section 13(a) or 15(d) of the Act (15 U.S.C. 78m(a) or 78o(d)).

(e) Definitions. Unless the context otherwise requires, all terms used in this section have the same meaning as in the Act. In addition, unless the context otherwise requires, the following definitions apply for purposes of this section:

(1)

(i) The term affiliate of, or a person affiliated with, a specified person, means a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.

(ii)

(A) A person will be deemed not to be in control of a specified person for purposes of this section if the person:

(1) Is not the beneficial owner, directly or indirectly, of more than 10% of any class of voting equity securities of the specified person; and



(2) Is not an executive officer of the specified person.

(B) Paragraph (e)(1)(ii)(A) of this section only creates a safe harbor position that a person does not control a specified person. The existence of the safe harbor does not create a presumption in any way that a person exceeding the ownership requirement in paragraph (e)(1)(ii)(A)(1) of this section controls or is otherwise an affiliate of a specified person.

(iii) The following will be deemed to be affiliates:

(A) An executive officer of an affiliate;

(B) A director who also is an employee of an affiliate;

(C) A general partner of an affiliate; and

(D) A managing member of an affiliate.

(iv) For purposes of paragraph (e)(1)(i) of this section, dual holding companies will not be deemed to be affiliates of or persons affiliated with each other by virtue of their dual holding company arrangements with each other, including where directors of one dual holding company are also directors of the other dual holding company, or where directors of one or both dual holding companies are also directors of the businesses jointly controlled, directly or indirectly, by the dual holding companies (and, in each case, receive only ordinary-course compensation for serving as a member of the board of directors, audit committee or any other board committee of the dual holding companies or any entity that is jointly controlled, directly or indirectly, by the dual holding companies).

(2) In the case of foreign private issuers with a two-tier board system, the term board of directors means the supervisory or non-management board.

(3) In the case of a listed issuer that is a limited partnership or limited liability company where such entity does not have a board of directors or equivalent body, the term board of directors means the board of directors of the managing general partner, managing member or equivalent body.

(4) The term control (including the terms controlling, controlled by and under common control with) means the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise.

(5) The term dual holding companies means two foreign private issuers that:

(i) Are organized in different national jurisdictions;

(ii) Collectively own and supervise the management of one or more businesses which are conducted as a single economic enterprise; and

(iii) Do not conduct any business other than collectively owning and supervising such businesses and activities reasonably incidental thereto.

(6) The term executive officer has the meaning set forth in §240.3b-7.

(7) The term foreign private issuer has the meaning set forth in §240.3b-4(c).

(8) The term indirect acceptance by a member of an audit committee of any consulting, advisory or other compensatory fee includes acceptance of such a fee by a spouse, a minor child or stepchild or a child or stepchild sharing a home with the member or by an entity in which such member is a partner, member, an officer such as a managing director occupying a comparable position or executive officer, or occupies a similar position (except limited partners, non-managing members and those occupying similar positions who, in each case, have no active role in providing services to the entity) and which provides accounting, consulting, legal, investment banking or financial advisory services to the issuer or any subsidiary of the issuer.

(9) The terms listed and listing refer to securities listed on a national securities exchange or listed in an automated inter-dealer quotation system of a national securities association or to issuers of such securities.

#### Instructions to §240.10A-3:

1. The requirements in paragraphs (b)(2) through (b)(5), (c)(3)(v) and (c)(3)(vi) of this section do not conflict with, and do not affect the application of, any requirement or ability under a listed issuer's governing law or documents or other home country legal or listing provisions that requires or permits shareholders to ultimately vote on, approve or ratify such requirements. The requirements instead relate to the assignment of responsibility as between the audit committee and management. In such an instance, however, if the listed issuer provides a recommendation or nomination regarding such responsibilities to shareholders, the audit committee of the listed issuer, or body performing similar functions, must be responsible for making the recommendation or nomination.

2. The requirements in paragraphs (b)(2) through (b)(5), (c)(3)(v), (c)(3)(vi) and Instruction 1 of this section do not conflict with any legal or listing requirement in a listed issuer's home jurisdiction that prohibits the full board of directors from delegating such responsibilities to the listed issuer's audit committee or limits the degree of such delegation. In that case, the audit committee, or body performing similar functions, must be granted such responsibilities, which can include advisory powers, with respect to such matters to the extent permitted by law, including submitting nominations or recommendations to the full board.

3. The requirements in paragraphs (b)(2) through (b)(5), (c)(3)(v) and (c)(3)(vi) of this section do not conflict with any legal or listing requirement in a listed issuer's home jurisdiction that vests such responsibilities with a government entity or tribunal. In that case, the audit committee, or body performing similar functions, must be granted such responsibilities, which can include advisory powers, with respect to such matters to the extent permitted by law.

4. For purposes of this section, the determination of a person's beneficial ownership must be made in accordance with §240.13d-3.

See also the relevant provisions of SEC Regulation S-K, Item 407, 17 CFR §229.407(d)(2) – If a listed issuer's board of directors determines, in accordance with the listing standards applicable to the issuer, to appoint a director to the audit committee who is not independent (apart from the requirements in §240.10A-3 of this chapter), including as a result of exceptional or limited or similar circumstances, disclose the nature of the relationship that makes that individual not independent and the reasons for the board of directors' determination.

#### 2. Disclosure of Audit Committee Financial Expert

Regarding the audit committee financial expert and disclosure of that expert 15 USC §7265 provides as follows:

(a) Rules defining “financial expert”

The Commission shall issue rules, as necessary or appropriate in the public interest and consistent with the protection of investors, to require each issuer, together with periodic reports required pursuant to sections 78m (a) and 78o (d) of this title, to disclose whether or not, and if not, the reasons therefor, the audit committee of that issuer is comprised of at least 1 member who is a financial expert, as such term is defined by the Commission.

(b) Considerations

In defining the term “financial expert” for purposes of subsection (a) of this section, the Commission shall consider whether a 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—

- (1) an understanding of generally accepted accounting principles and financial statements;
- (2) experience in—
  - (A) the preparation or auditing of financial statements of generally comparable issuers; and
  - (B) the application of such principles in connection with the accounting for estimates, accruals, and reserves;
- (3) experience with internal accounting controls; and
- (4) an understanding of audit committee functions.

(c) Deadline for rulemaking

The Commission shall—

- (1) propose rules to implement this section, not later than 90 days after July 30, 2002; and
- (2) issue final rules to implement this section, not later than 180 days after July 30, 2002.

See also the relevant provisions of SEC Regulation S-K, Item 407, 17 CFR §229.407(d)(5):

(5) Audit committee financial expert. (i)(A) Disclose that the registrant's board of directors has determined that the registrant either:

- (1) Has at least one audit committee financial expert serving on its audit committee; or

(2) Does not have an audit committee financial expert serving on its audit committee.

(B) If the registrant provides the disclosure required by paragraph (d)(5)(i)(A)(1) of this Item, it must disclose the name of the audit committee financial expert and whether that person is independent, as independence for audit committee members is defined in the listing standards applicable to the listed issuer.

(C) If the registrant provides the disclosure required by paragraph (d)(5)(i)(A)(2) of this Item, it must explain why it does not have an audit committee financial expert.

Instruction to Item 407(d)(5)(i). If the registrant's board of directors has determined that the registrant has more than one audit committee financial expert serving on its audit committee, the registrant may, but is not required to, disclose the names of those additional persons. A registrant choosing to identify such persons must indicate whether they are independent pursuant to paragraph (d)(5)(i)(B) of this Item.

(ii) For purposes of this Item, an audit committee financial expert means a person who has the following attributes:

(A) An understanding of generally accepted accounting principles and financial statements;

(B) The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves;

(C) Experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;

(D) An understanding of internal control over financial reporting; and

(E) An understanding of audit committee functions.

(iii) A person shall have acquired such attributes through:

(A) 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;

(B) Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;

(C) Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or

(D) Other relevant experience.

(iv) Safe harbor. (A) A person who is determined to be an audit committee financial expert will not be deemed an expert for any purpose, including without limitation for purposes of section 11 of the Securities Act (15 U.S.C. 77k), as a result of being designated or identified as an audit committee financial expert pursuant to this Item 407.

(B) The designation or identification of a person as an audit committee financial expert pursuant to this Item 407 does not impose on such person any duties, obligations or liability that are greater than the duties, obligations and liability imposed on such person as a member of the audit committee and board of directors in the absence of such designation or identification.

(C) The designation or identification of a person as an audit committee financial expert pursuant to this Item does not affect the duties, obligations or liability of any other member of the audit committee or board of directors.

Instructions to Item 407(d)(5). 1. The disclosure under paragraph (d)(5) of this Item is required only in a registrant's annual report. The registrant need not provide the disclosure required by paragraph (d)(5) of this Item in a proxy or information statement unless that registrant is electing to incorporate this information by reference from the proxy or information statement into its annual report pursuant to General Instruction G(3) to Form 10-K (17 CFR §249.310).

2. If a person qualifies as an audit committee financial expert by means of having held a position described in paragraph (d)(5)(iii)(D) of this Item, the registrant shall provide a brief listing of that person's relevant experience. Such disclosure may be made by reference to disclosures required under Item 401(e) (§229.401(e)).

## B. Stock Exchange (SRO) Rules

1. NYSE Listed Company Manual, <http://nysemanual.nyse.com/lcm/>

### a. Audit Committee Required

Section 303A.06 of the New York Stock Exchange Listed Company Manual requires that each listed company have an audit committee that satisfies the requirements of SEC Rule 10A-3 of the Securities Exchange Act of 1934 (17 CFR §240.10A-3).

*Commentary:* The Exchange will apply the requirements of Rule 10A-3 in a manner consistent with the guidance provided by the Securities and Exchange Commission in SEC Release No. 34-47654 (April 1, 2003). Without limiting the generality of the foregoing, the Exchange will provide companies the opportunity to cure defects provided in Rule 10A-3(a)(3) under the Exchange Act.

**Disclosure Requirement:** Please note that Rule 10A-3(d)(1) and (2) require listed companies to disclose reliance on certain exceptions from Rule 10A-3 and to disclose an assessment of whether, and if so, how, such reliance would materially adversely affect the ability of the audit committee to act independently and to satisfy the other requirements of Rule 10A-3.

### b. Audit Committee Composition and Other Requirements

Section 303A.07, New York Stock Exchange Listed Company Manual, Audit Committee Additional Requirements

**(a)** The audit committee must have a minimum of three members. All audit committee members must satisfy the requirements for independence set out in Section 303A.02 and, in the absence of an applicable exemption, Rule 10A-3(b)(1).

*Commentary:* Each member of the audit committee must be financially literate, as such qualification is interpreted by the listed company's board in its business judgment, or must become financially literate within a reasonable period of time after his or her appointment to the audit committee. In addition, at least one member of the audit committee must have accounting or related financial management expertise, as the listed company's board interprets such qualification in its business judgment. While the Exchange does not require that a listed company's audit committee include a person who satisfies the definition of audit committee financial expert set out in Item 407(d)(5)(ii) of Regulation S-K, a board may presume that such a person has accounting or related financial management expertise.

Because of the audit committee's demanding role and responsibilities, and the time commitment attendant to committee membership, each prospective audit committee member should evaluate carefully the existing demands on his or her time before accepting this important assignment.

*Disclosure Requirement:* If an audit committee member simultaneously serves on the audit committees of more than three public companies, 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 must disclose such determination either on or through the listed company's website or in its annual proxy statement or, if the listed company does not file an annual proxy statement, in its annual report on Form 10-K filed with the SEC. If this disclosure is made on or through the listed company's website, the listed company must disclose that fact in its annual proxy statement or annual report, as applicable, and provide the website address.

### c. Independence Tests

Pursuant to section 303A.01 of the New York Stock Exchange Listed Company Manual, listed companies must have a majority of independent directors.

*Commentary:* Effective boards of directors exercise independent judgment in carrying out their responsibilities. Requiring a majority of independent directors will increase the quality of board oversight and lessen the possibility of damaging conflicts of interest.

### New York Stock Exchange Listed Company Manual section 303A.02 Independence Tests

In order to tighten the definition of "independent director" for purposes of these standards:

(a)(i) No director qualifies as "independent" unless the board of directors affirmatively determines that the director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company).

(ii) In addition, in affirmatively determining the independence of any director who will serve on the compensation committee of the listed company's board of directors, the board of directors must consider all factors specifically relevant to determining whether a director has a

relationship to the listed company which is material to that director's ability to be independent from management in connection with the duties of a compensation committee member, including, but not limited to:

(A) the source of compensation of such director, including any consulting, advisory or other compensatory fee paid by the listed company to such director; and

(B) whether such director is affiliated with the listed company, a subsidiary of the listed company or an affiliate of a subsidiary of the listed company.

*Commentary:* It is not possible to anticipate, or explicitly to provide for, all circumstances that might signal potential conflicts of interest, or that might bear on the materiality of a director's relationship to a listed company (references to "listed company" would include any parent or subsidiary in a consolidated group with the listed company). Accordingly, it is best that boards making "independence" determinations broadly consider all relevant facts and circumstances. In particular, when assessing the materiality of a director's relationship with the listed company, the board should consider the issue not merely from the standpoint of the director, but also from that of persons or organizations with which the director has an affiliation. Material relationships can include commercial, industrial, banking, consulting, legal, accounting, charitable and familial relationships, among others. However, as the concern is independence from management, the Exchange does not view ownership of even a significant amount of stock, by itself, as a bar to an independence finding.

When considering the sources of a director's compensation in determining his independence for purposes of compensation committee service, the board should consider whether the director receives compensation from any person or entity that would impair his ability to make independent judgments about the listed company's executive compensation. Similarly, when considering any affiliate relationship a director has with the company, a subsidiary of the company, or an affiliate of a subsidiary of the company, in determining his independence for purposes of compensation committee service, the board should consider whether the affiliate relationship places the director under the direct or indirect control of the listed company or its senior management, or creates a direct relationship between the director and members of senior management, in each case of a nature that would impair his ability to make independent judgments about the listed company's executive compensation.

*Disclosure Requirement:* The listed company must comply with the disclosure requirements set forth in Item 407(a) of Regulation S-K.

(b) In addition, a director is not independent if:

(i) The director is, or has been within the last three years, an employee of the listed company, or an immediate family member is, or has been within the last three years, an executive officer, of the listed company.

*Commentary:* Employment as an interim Chairman or CEO or other executive officer shall not disqualify a director from being considered independent following that employment.

(ii) The director has received, or has an immediate family member who has received, during any twelve-month period within the last three years, more than \$120,000 in direct compensation from the listed company, other than director and committee fees and pension or other forms of deferred compensation for prior service (provided such compensation is not contingent in any way on continued service).

*Commentary:* Compensation received by a director for former service as an interim Chairman or CEO or other executive officer need not be considered in determining independence under this test. Compensation received by an immediate family member for service as an employee of the listed company (other than an executive officer) need not be considered in determining independence under this test.

(iii) (A) The director is a current partner or employee of a firm that is the listed company's internal or external auditor; (B) the director has an immediate family member who is a current partner of such a firm; (C) the director has an immediate family member who is a current employee of such a firm and personally works on the listed company's audit; or (D) the director or an immediate family member was within the last three years a partner or employee of such a firm and personally worked on the listed company's audit within that time.

(iv) The director or an immediate family member is, or has been with the last three years, employed as an executive officer of another company where any of the listed company's present executive officers at the same time serves or served on that company's compensation committee.

(v) The director is a current employee, or an immediate family member is a current executive officer, of a company that has made payments to, or received payments from, the listed company for property or services in an amount which, in any of the last three fiscal years, exceeds the greater of \$1 million, or 2% of such other company's consolidated gross revenues.

*Commentary:* In applying the test in Section 303A.02(b)(v), both the payments and the consolidated gross revenues to be measured shall be those reported in the last completed fiscal year of such other company. The look-back provision for this test applies solely to the financial relationship between the listed company and the director or immediate family member's current employer; a listed company need not consider former employment of the director or immediate family member.

*Disclosure Requirement:* Contributions to tax exempt organizations shall not be considered payments for purposes of Section 303A.02(b)(v), provided however that a listed company shall disclose either on or through its website or in its annual proxy statement, or if the listed company does not file an annual proxy statement, in the listed company's annual report on Form 10-K filed with the SEC, any such contributions made by the listed company to any tax exempt organization in which any independent director serves as an executive officer if, within the preceding three years, contributions in any single fiscal year from the listed company to the organization exceeded the greater of \$1 million, or 2% of such tax exempt organization's consolidated gross revenues. If this disclosure is made on or through the listed company's website, the listed company must disclose that fact in its annual proxy statement or annual report, as applicable, and



provide the website address. Listed company boards are reminded of their obligations to consider the materiality of any such relationship in accordance with Section 303A.02(a) above.

*General Commentary to Section 303A.02(b):* An "immediate family member" includes a person's spouse, parents, children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, and anyone (other than domestic employees) who shares such person's home. When applying the look-back provisions in Section 303A.02(b), listed companies need not consider individuals who are no longer immediate family members as a result of legal separation or divorce, or those who have died or become incapacitated.

In addition, references to the "listed company" or "company" include any parent or subsidiary in a consolidated group with the listed company or such other company as is relevant to any determination under the independent standards set forth in this Section 303A.02(b).

For purposes of Section 303A, the term "executive officer" has the same meaning specified for the term "officer" in Rule 16a-1(f) under the Securities Exchange Act of 1934.

## 2. NASDAQ Stock Market Rules, <http://nasdaq.cchwallstreet.com/>

### a. Audit Committee Composition

Nasdaq Stock Market Manual Rule 5605(c)(2), Audit Committee Composition, provides as follows:

#### (2) Audit Committee Composition

(A) Each Company must have, and certify that it has and will continue to have, an audit committee of at least three members, each of whom must: (i) be an Independent Director as defined under Rule 5605(a)(2); (ii) meet the criteria for independence set forth in Rule 10A-3(b)(1) under the Act (subject to the exemptions provided in Rule 10A-3(c) under the Act); (iii) 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; and (iv) be able to read and understand fundamental financial statements, including a Company's balance sheet, income statement, and cash flow statement. Additionally, each Company must certify that it has, and will continue to have, at least one member of the audit committee who has past employment experience in finance or accounting, requisite professional certification in accounting, or any 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.

#### (B) Non-Independent Director for Exceptional and Limited Circumstances

Notwithstanding paragraph (2)(A)(i), one director who: (i) is not an Independent Director as defined in Rule 5605(a)(2); (ii) meets the criteria set forth in Section 10A(m)(3) under the Act and the rules thereunder; and (iii) is not currently an Executive Officer or employee or a Family Member of an Executive Officer, may be appointed to the audit committee, if the board, under exceptional and limited circumstances, determines that membership on the committee by the

individual is required by the best interests of the Company and its Shareholders. A Company, other than a Foreign Private Issuer, that relies on this exception must comply with the disclosure requirements set forth in Item 407(d)(2) of Regulation S-K. A Foreign Private Issuer that relies on this exception must disclose in its next annual report (e.g., Form 20-F or 40-F) the nature of the relationship that makes the individual not independent and the reasons for the board's determination. A member appointed under this exception may not serve longer than two years and may not chair the audit committee.

#### IM-5605-4. Audit Committee Composition

Audit committees are required to have a minimum of three members and be comprised only of Independent Directors. In addition to satisfying the Independent Director requirements under Rule 5605(a)(2), audit committee members must meet the criteria for independence set forth in Rule 10A-3(b)(1) under the Act (subject to the exemptions provided in Rule 10A-3(c) under the Act): they must not accept any consulting, advisory, or other compensatory fee from the Company other than for board service, and they must not be an affiliated person of the Company. As described in Rule 10A-3(d)(1) and (2), a Company must disclose reliance on certain exceptions from Rule 10A-3 and disclose an assessment of whether, and if so, how, such reliance would materially adversely affect the ability of the audit committee to act independently and to satisfy the other requirements of Rule 10A-3. It is recommended also that a Company disclose in its annual proxy (or, if the Company does not file a proxy, in its Form 10-K or 20-F) if any director is deemed eligible to serve on the audit committee but falls outside the safe harbor provisions of Rule 10A-3(e)(1)(ii) under the Act. A director who qualifies as an audit committee financial expert under Item 407(d)(5)(ii) and (iii) of Regulation S-K is presumed to qualify as a financially sophisticated audit committee member under Rule 5605(c)(2)(A).

Nasdaq Stock Market Manual Rule 5605(c)(4) and (5), Cure Periods for Audit Committees, and Exception, respectively, provide as follows:

#### (4) Cure Periods for Audit Committee

(A) If a Company fails to comply with the audit committee composition requirement under Rule 10A-3(b)(1) under the Act and Rule 5605(c)(2)(A) because an audit committee member ceases to be independent for reasons outside the member's reasonable control, the audit committee member may remain on the audit committee until the earlier of its next annual shareholders meeting or one year from the occurrence of the event that caused the failure to comply with this requirement. A Company relying on this provision must provide notice to Nasdaq immediately upon learning of the event or circumstance that caused the noncompliance.

(B) If a Company fails to comply with the audit committee composition requirement under Rule 5605(c)(2)(A) due to one vacancy on the audit committee, and the cure period in paragraph (A) is not otherwise being relied upon for another member, 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; provided, however, that if the annual shareholders meeting occurs no later than 180 days following the event that caused the vacancy, the Company shall instead have 180 days from such event to regain compliance. A Company relying on this

provision must provide notice to Nasdaq immediately upon learning of the event or circumstance that caused the noncompliance.

#### (5) Exception

At any time when a Company has a class of common equity securities (or similar securities') that is listed on another national securities exchange or national securities association subject to the requirements of Rule 10A-3 under the Act, the listing of classes of securities of a direct or indirect consolidated subsidiary or an at least 50% beneficially owned subsidiary of the Company (except classes of equity securities, other than non-convertible, non-participating preferred securities, of such subsidiary) shall not be subject to the requirements of Rule 5605(c).

#### b. Independent Director Defined

Nasdaq Stock Market Manual Rule 5605(b)(1), Independent Directors, provides as follows:

#### (b) Independent Directors

##### (1) Majority Independent Board

A majority of the board of directors must be comprised of Independent Directors as defined in Rule 5605(a)(2). The Company, other than a Foreign Private Issuer, must comply with the disclosure requirements set forth in Item 407(a) of Regulation S-K. A Foreign Private Issuer must disclose in its next annual report (e.g., Form 20-F or 40-F) those directors that the board of directors has determined to be independent under Rule 5605(a)(2).

##### (A) Cure Period for Majority Independent Board

If a Company fails to comply with this requirement due to one vacancy, or one director ceases to be independent due to circumstances beyond their reasonable control, the Company shall regain compliance with the requirement by the earlier of its next annual shareholders meeting or one year from the occurrence of the event that caused the failure to comply with this requirement; provided, however, that if the annual shareholders meeting occurs no later than 180 days following the event that caused the failure to comply with this requirement, the Company shall instead have 180 days from such event to regain compliance. A Company relying on this provision shall provide notice to Nasdaq immediately upon learning of the event or circumstance that caused the noncompliance.

#### IM-5605-1. Majority Independent Board

Majority Independent Board. Independent Directors (as defined in Rule 5605(a)(2)) play an important role in assuring investor confidence. Through the exercise of independent judgment, they act on behalf of investors to maximize shareholder value in the Companies they oversee and guard against conflicts of interest. Requiring that the board be comprised of a majority of

Independent Directors empowers such directors to carry out more effectively these responsibilities.

Additionally, Nasdaq Stock Market Manual Rule 5605(a), Board of Directors and Committees/Definitions, further provides:

5605. Board of Directors and Committees

(a) Definitions

(1) "Executive Officer" means those officers covered in Rule 16a-1(f) under the Act.

(2) "Independent Director" means a person other than an Executive Officer or employee of the Company or any other individual having a relationship which, in the opinion of the Company's board of directors, would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. For purposes of this rule, "Family Member" means a person's spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone residing in such person's home. The following persons shall not be considered independent:

(A) a director who is, or at any time during the past three years was, employed by the Company;

(B) a director who accepted or who has a Family Member who accepted any compensation from the Company in excess of \$120,000 during any period of twelve consecutive months within the three years preceding the determination of independence, other than the following:

(i) compensation for board or board committee service;

(ii) compensation paid to a Family Member who is an employee (other than an Executive Officer) of the Company; or

(iii) benefits under a tax-qualified retirement plan, or non-discretionary compensation.

Provided, however, that in addition to the requirements contained in this paragraph (B), audit committee members are also subject to additional, more stringent requirements under Rule 5605(c)(2).

(C) a director who is a Family Member of an individual who is, or at any time during the past three years was, employed by the Company as an Executive Officer;

(D) a director who is, or has a Family Member who is, a partner in, or a 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, other than the following:

(i) payments arising solely from investments in the Company's securities; or

(ii) payments under non-discretionary charitable contribution matching programs.

(E) a director of the Company who is, or has a Family Member who is, 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 serve on the compensation committee of such other entity; or

(F) a director who is, or has a Family Member who is, a current partner of the Company's outside auditor, or was a partner or employee of the Company's outside auditor who worked on the Company's audit at any time during any of the past three years.

(G) in the case of an investment company, in lieu of paragraphs (A)-(F), a director who is an "interested person" of the Company as defined in Section 2(a)(19) of the Investment Company Act of 1940, other than in his or her capacity as a member of the board of directors or any board committee.

#### IM-5605. Definition of Independence – Rule 5605(a)(2)

It is important for investors to have confidence that individuals serving as Independent Directors do not have a relationship with the listed Company that would impair their independence. The board has a responsibility to make an affirmative determination that no such relationships exist through the application of Rule 5605(a)(2). Rule 5605(a)(2) also provides a list of certain relationships that preclude a board finding of independence. These objective measures provide transparency to investors and Companies, facilitate uniform application of the rules, and ease administration. Because Nasdaq does not believe that ownership of Company stock by itself would preclude a board finding of independence, it is not included in the aforementioned objective factors. It should be noted that there are additional, more stringent requirements that apply to directors serving on audit committees, as specified in Rule 5605(c).

The Rule's reference to the "Company" includes any parent or subsidiary of the Company. The term "parent or subsidiary" is intended to cover entities the Company controls and consolidates with the Company's financial statements as filed with the Commission (but not if the Company reflects such entity solely as an investment in its financial statements). The reference to Executive Officer means those officers covered in Rule 16a-1(f) under the Act. In the context of the definition of Family Member under Rule 5605(a)(2), the reference to marriage is intended to capture relationships specified in the Rule (parents, children and siblings) that arise as a result of marriage, such as "in-law" relationships.

The three year look-back periods referenced in paragraphs (A), (C), (E) and (F) of the Rule commence on the date the relationship ceases. For example, a director employed by the Company is not independent until three years after such employment terminates.

For purposes of paragraph (A) of the Rule, employment by a director as an Executive Officer on an interim basis shall not disqualify that director from being considered independent following such employment, provided the interim employment did not last longer than one year. A director would not be considered independent while serving as an interim officer. Similarly, for purposes

of paragraph (B) of the Rule, compensation received by a director for former service as an interim Executive Officer need not be considered as compensation in determining independence after such service, provided such interim employment did not last longer than one year. Nonetheless, the Company's board of directors still must consider whether such former employment and any compensation received would interfere with the director's exercise of independent judgment in carrying out the responsibilities of a director. In addition, if the director participated in the preparation of the Company's financial statements while serving as an interim Executive Officer, Rule 5605(c)(2)(A)(iii) would preclude service on the audit committee for three years.

Paragraph (B) of the Rule is generally intended to capture situations where a compensation is made directly to (or for the benefit of) the director or a Family Member of the director. For example, consulting or personal service contracts with a director or Family Member of the director would be analyzed under paragraph (B) of the Rule. In addition, political contributions to the campaign of a director or a Family Member of the director would be considered indirect compensation under paragraph (B). Non-preferential payments made in the ordinary course of providing business services (such as payments of interest or proceeds related to banking services or loans by a Company that is a financial institution or payment of claims on a policy by a Company that is an insurance company), payments arising solely from investments in the Company's securities and loans permitted under Section 13(k) of the Act will not preclude a finding of director independence as long as the payments are non-compensatory in nature. Depending on the circumstances, a loan or payment could be compensatory if, for example, it is not on terms generally available to the public.

Paragraph (D) of the Rule is generally intended to capture payments to an entity with which the director or Family Member of the director is affiliated by serving as a partner, controlling Shareholder or Executive Officer of such entity. Under exceptional circumstances, such as where a director has direct, significant business holdings, it may be appropriate to apply the corporate measurements in paragraph (D), rather than the individual measurements of paragraph (B). Issuers should contact Nasdaq if they wish to apply the Rule in this manner. The reference to a partner in paragraph (D) is not intended to include limited partners. It should be noted that the independence requirements of paragraph (D) of the Rule are broader than Rule 10A-3(e)(8) under the Act.

Under paragraph (D), a director who is, or who has a Family Member who is, an Executive Officer of a charitable organization may not be considered independent if the Company makes payments to the charity in excess of the greater of 5% of the charity's revenues or \$200,000. However, Nasdaq encourages Companies to consider other situations where a director or their Family Member and the Company each have a relationship with the same charity when assessing director independence.

For purposes of determining whether a lawyer is eligible to serve on an audit committee, Rule 10A-3 under the Act generally provides that any partner in a law firm that receives payments from the issuer is ineligible to serve on that issuer's audit committee. In determining whether a director may be considered independent for purposes other than the audit committee, payments to a law firm would generally be considered under Rule 5605(a)(2), which looks to whether the

payment exceeds the greater of 5% of the recipient's gross revenues or \$200,000; however, if the firm is a sole proprietorship, Rule 5605(a)(2)(B), which looks to whether the payment exceeds \$120,000, applies.

Paragraph (G) of the Rule provides a different measurement for independence for investment companies in order to harmonize with the Investment Company Act of 1940. In particular, in lieu of paragraphs (A)-(F), a director who is an "interested person" of the Company as defined in Section 2(a)(19) of the Investment Company Act of 1940, other than in his or her capacity as a member of the board of directors or any board committee, shall not be considered independent.

[Hyperlink Back to Main Table of Contents](#)

## V. COMMITTEE FUNCTIONS AND RESPONSIBILITIES

### A. Federal Statutes and Regulations, and Related Rules

#### 1. Public Company Audit Committee Responsibilities

15 USC §78j-1(m)(2) – With Respect to the External Auditor:

The audit committee of each issuer, in its capacity as a committee of the board of directors, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the audit committee.

15 USC §78j-1(m)(4) – Complaints:

Each audit committee shall establish procedures for—

(A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and

(B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

15 USC §78j-1(m)(5) – Advisors:

Each audit committee shall have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.

15 USC §78j-1(m)(6) – Funding:

Each issuer shall provide for appropriate funding, as determined by the audit committee, in its capacity as a committee of the board of directors, for payment of compensation—

(A) to the registered public accounting firm employed by the issuer for the purpose of rendering or issuing an audit report; and

(B) to any advisers employed by the audit committee under paragraph (5).

SEC Regulation S-K, Item 407, 17 CFR §229.407(d)(1):

Requires the company to state whether or not the audit committee has a charter.

SEC Regulation S-K, Item 407, 17 CFR §229.407(d)(3):

(3)

(i) The audit committee must state whether:

(A) The audit committee has reviewed and discussed the audited financial statements with management;

(B) The audit committee has discussed with the independent auditors the matters required to be discussed by the Statement on Auditing Standards No. 61, as amended (AICPA, *Professional Standards*, Vol. 1. AU section 380), as adopted by the Public Company Accounting Oversight Board in Rule 3200T (available at [http://www.pcaobus.org/standards/interim\\_standards/auditing\\_standards/index\\_au.asp?series=300&section=300](http://www.pcaobus.org/standards/interim_standards/auditing_standards/index_au.asp?series=300&section=300).) (Note: SAS no. 61 is now superseded; see SAS 114 and PCAOB AS no. 16, both of which are discussed at part VI of these materials);

(C) The audit committee has received the written disclosures and the letter from the independent accountant required by applicable requirements of the Public Company Accounting Oversight Board regarding the independent accountant's communications with the audit committee concerning independence, and has discussed with the independent accountant the independent accountant's independence; and

(D) Based on the review and discussions referred to in paragraphs (d)(3)(i)(A) through (d)(3)(i)(C) of this Item, 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 (17 CFR §249.310) (or, for closed-end investment companies registered under the Investment Company Act of 1940 (15 USC §§80a-1, et seq.), the annual report to shareholders required by section 30(e) of the Investment Company Act of 1940 (15 USC §80a-29(e)) and Rule 30d-1 (17 CFR §270.30d-1) thereunder) for the last fiscal year for filing with the Commission.

(ii) The name of each member of the company's audit committee (or, in the absence of an audit committee, the board committee performing equivalent functions or the entire board of directors) must appear below the disclosure required by paragraph (d)(3)(i) of this Item.

(4)



(i) If the registrant meets the following requirements, provide the disclosure in paragraph (d)(4)(ii) of this Item:

(A) The registrant is a listed issuer, as defined in §240.10A-3 of this chapter;

(B) The registrant is filing an annual report on Form 10-K (§249.310 of this chapter) or a proxy statement or information statement pursuant to the Exchange Act (15 USC §§78a, et seq.) if action is to be taken with respect to the election of directors; and

(C) The registrant is neither:

(1) A subsidiary of another listed issuer that is relying on the exemption in §240.10A-3(c)(2) of this chapter; nor

(2) Relying on any of the exemptions in §240.10A-3(c)(4) through (c)(7) of this chapter.

(ii)

(A) State whether or not the registrant has a separately-designated standing audit committee established in accordance with section 3(a)(58)(A) of the Exchange Act (15 USC §78c(a)(58)(A)), or a committee performing similar functions. If the registrant has such a committee, however designated, identify each committee member. If the entire board of directors is acting as the registrant's audit committee as specified in section 3(a)(58)(B) of the Exchange Act (15 USC §78c(a)(58)(B)), so state.

(B) If applicable, provide the disclosure required by § 240.10A-3(d) of this chapter regarding an exemption from the listing standards for audit committees.

See also SEC Regulation S-K, Item 304 (17 CFR §229.304), which in relevant part 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 external auditor that was engaged to audit the financial statements of the company or of a significant subsidiary of the company. The instructions to Item 304 define the term "disagreements" broadly to include any difference of opinion that was unresolved to the satisfaction of the former accountant, concerning any matter of accounting principles or practices, financial statements disclosure, or auditing scope or procedure, which would have caused the former accountant to make reference to the subject matter of the disagreement in connection with its report. Merely a difference of opinion will suffice.

## 2. Corporate Responsibility for Financial Reports

Pursuant to 15 USC §7241) 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.

Specifically with respect to the audit committee the principal executive officer or officers and the principal financial officer or officers, or persons performing similar functions, certify in each annual or quarterly report filed or submitted that:

- (1)** the signing officer has reviewed the report;
- (2)** based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading;
- (3)** based on such officer's 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 issuer as of, and for, the periods presented in the report;
- (4)** the signing officers:
  - (A)** are responsible for establishing and maintaining internal controls;
  - (B)** have designed such internal controls to ensure that material information relating to the issuer and its consolidated subsidiaries is made known to such officers by others within those entities, particularly during the period in which the periodic reports are being prepared;
  - (C)** have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and
  - (D)** have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;
- (5)** the signing officers have disclosed to the issuer's auditors and the audit committee of the board of directors (or persons fulfilling the equivalent function):
  - (A)** all significant deficiencies in the design or operation of internal controls which could adversely affect the issuer's ability to record, process, summarize, and report financial data and have identified for the issuer's auditors any material weaknesses in internal controls; and
  - (B)** any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and
- (6)** the signing officers have indicated in the report 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 with regard to significant deficiencies and material weaknesses.

### 3. Improper Influence on the Conduct of Audits

It is unlawful for any officer or director, or any other person acting under their direction to take any action to fraudulently influence, coerce, manipulate, or mislead the outside auditor for the purpose of making the company's financial statements materially misleading. 15 USC §7242.

### 4. Management Assessment of Internal Controls

In relevant part, 15 USC §7262 (Management assessment of internal controls) directs the SEC to prescribe rules requiring each annual report to contain an internal control report that states management's responsibility for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and that the annual report should contain an assessment, as of the end of the most recent fiscal year of the company, of the effectiveness of the company's internal control structure and procedures for financial reporting – 15 USC §7262 provides as follows:

(a)

#### Rules required

The Commission shall prescribe rules requiring each annual report required by section 78m (a) or 78o (d) of this title to contain an internal control report, which shall—

(1) state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and

(2) contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

(b)

#### Internal control evaluation and reporting

With respect to the internal control assessment required by subsection (a) of this section, each registered public accounting firm that prepares or issues the audit report for the issuer shall attest to, and report on, the assessment made by the management of the issuer. An attestation made under this subsection shall be made in accordance with standards for attestation engagements issued or adopted by the Board. Any such attestation shall not be the subject of a separate engagement.

This is a complicated topic area that I am covering in this summary format – although I will be adding to these materials, if you are aware of this topic area and internal controls you are aware that this topic also is the subject of publications that solely focus on this area. Initially §7262 was the subject of considerable discussion – there was considerable difficulty with the type of report that the external auditor was required to provide and whether that report was an attestation report. The SEC subsequently issued new rules pertaining to management's evaluation, and the outside auditor's attestation report on the effectiveness, of internal control over financial reporting. The new SEC guidance in part revised requirements regarding the outside auditor's attestation report. The auditor must provide an opinion on the effectiveness of internal control over financial reporting to protect against the risk of material financial misstatement, but is no longer required to provide an opinion on management's evaluation process. The SEC also amended its rules on the definition of the term "material weakness".

In conjunction with the new SEC guidance the Public Company Accounting Oversight Board (PCAOB) adopted Auditing Standard No. 5 ("An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements") to replace the previous internal control auditing standard (Auditing Standard No. 2). Auditing Standard No. 5 is discussed in these materials at VI.

The difficulties that had been caused by §7262 in no small part arose from a lack of guidance

regarding the scope, complexity, design, testing, effectiveness, and documentation of internal controls necessary to satisfy §7262 and the outside auditor's 'attestation. Auditing Standard No. 5 is more principles-based, with a view toward materiality, which should allow a company to better focus the emphasis of its internal controls to fit its particular needs and circumstances, and to avoid spending time and resources on materially unnecessary items.

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. Internal control over financial reporting includes those policies and procedures that (see 17 CFR §240.13a-15(f) and 17 CFR §240.15d-15(f)):

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the company;
- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the 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 the unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

See also 15 USC §78m(b)(2), generally requiring each issuing company to devise and maintain a sufficient system of internal accounting controls.

Regulation S-K, Item 308 ("Internal Control over Financial Reporting"; 17 CFR §229.308) requires management's annual report on the company's internal control over financial reporting (as defined in 17 CFR §240.13a-15(f) or 17 CFR §240.15d-15(f)) to contain:

- A statement of management's responsibility for establishing and maintaining adequate internal control over financial reporting for the company.
- A statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting as required by paragraph (c) of Rule §240.13a-15 or Rule §240.15d-15 under the Exchange Act.
- Management's assessment of the effectiveness of the company's internal control over financial reporting as of the end of the company's most recent fiscal year, including a statement of whether or not internal control over financial reporting is effective. This discussion must include disclosure of any material weakness in the company's internal control over financial reporting identified by management. Management is not permitted to conclude that the company's internal control over financial reporting is effective if there are one or more material weaknesses in the company's internal control over financial reporting.
- A statement that the outside auditor that audited the financial statements has issued an attestation report on management's assessment of the company's internal control over financial reporting in keeping with the SEC's requirements about the nature and scope of that report.

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

See also SEC Release Nos. 33-8238 and 34-47986 at <http://www.sec.gov/rules/final/33-8238.htm>, PCAOB AS 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements at part VI of these materials and at [http://pcaobus.org/Standards/Auditing/Pages/Auditing\\_Standard\\_5.aspx](http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_5.aspx), and AU Section 325 Communications About Control Deficiencies in an Audit of Financial Statements at <http://pcaobus.org/standards/auditing/pages/au325b.aspx>.

## 5. Code of Ethics for Senior Financial Officers

Pursuant to 15 USC §7264 the Securities and Exchange Commission is required to issue rules requiring each issuer company together with periodic reports required pursuant to section 78m (a) or 78o (d), to disclose whether or not, and if not, the reason therefor, such issuer has adopted a code of ethics for senior financial officers, applicable to its principal financial officer and comptroller or principal accounting officer, or persons performing similar functions. Section 7264 further provides that the Commission shall revise its regulations concerning matters requiring prompt disclosure on Form 8-K (or any successor thereto) to require the immediate disclosure, by means of the filing of such form, dissemination by the Internet or by other electronic means, by any issuer of any change in or waiver of the code of ethics for senior financial officers.

Section 7264 provides that the term "code of ethics" means such standards as are reasonably necessary to promote—

- (1) honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
- (2) full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer; and
- (3) compliance with applicable governmental rules and regulations.

Regulation S-K, Item 406, further provides as follows:

§229.406 (Item 406) Code of Ethics.

(a) Disclose whether the registrant has adopted a code of ethics that applies to the registrant's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. If the registrant has not adopted such a code of ethics, explain why it has not done so.

(b) For purposes of this Item 406, the term *code of ethics* means written standards that are reasonably designed to deter wrongdoing and to promote:

- (1) Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;

(2) Full, fair, accurate, timely, and understandable disclosure in reports and documents that a registrant files with, or submits to, the Commission and in other public communications made by the registrant;

(3) Compliance with applicable governmental laws, rules and regulations;

(4) The prompt internal reporting of violations of the code to an appropriate person or persons identified in the code; and

(5) Accountability for adherence to the code.

(c) The registrant must:

(1) File with the Commission a copy of its code of ethics that applies to the registrant's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions, as an exhibit to its annual report;

(2) Post the text of such code of ethics on its Internet website and disclose, in its annual report, its Internet address and the fact that it has posted such code of ethics on its Internet Web site; or

(3) Undertake in its annual report filed with the Commission to provide to any person without charge, upon request, a copy of such code of ethics and explain the manner in which such request may be made.

(d) If the registrant intends to satisfy the disclosure requirement under Item 10 of Form 8-K regarding an amendment to, or a waiver from, a provision of its code of ethics that applies to the registrant's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions and that relates to any element of the code of ethics definition enumerated in paragraph (b) of this Item by posting such information on its Internet website, disclose the registrant's Internet address and such intention.

*Instructions to Item 406.* 1. A registrant may have separate codes of ethics for different types of officers. Furthermore, a *code of ethics* within the meaning of paragraph (b) of this Item may be a portion of a broader document that addresses additional topics or that applies to more persons than those specified in paragraph (a). In satisfying the requirements of paragraph (c), a registrant need only file, post or provide the portions of a broader document that constitutes a *code of ethics* as defined in paragraph (b) and that apply to the persons specified in paragraph (a).

2. If a registrant elects to satisfy paragraph (c) of this Item by posting its code of ethics on its website pursuant to paragraph (c)(2), the code of ethics must remain accessible on its Web site for as long as the registrant remains subject to the requirements of this Item and chooses to comply with this Item by posting its code on its Web site pursuant to paragraph (c)(2).

## 6. Real-Time Issuer Disclosures

Pursuant to 15 USC §78m(l) each issuer must “disclose to the public on a rapid and current basis such additional information concerning material changes in the financial condition or operations of the issuer, in plain English, which may include trend and qualitative information and graphic presentations, as the Commission determines, by rule, is necessary or useful for the protection of investors and in the public interest.” See also Regulation S-K, Item 307 (disclosure controls and procedures) (17 CFR §229.307) requiring the issuer to disclose the conclusions of

the principal executive and principal financial officers, or persons performing similar functions, regarding the effectiveness of the registrant's disclosure controls and procedures (as defined in §240.13a-15(e) or §240.15d-15(e)) as of the end of the period covered by the report, based on the evaluation of these controls and procedures required by paragraph (b) of §240.13a-15 or §240.15d-15.

## 7. Whistleblower and Anti-Retaliation Provisions

### a. Protection for Employees of Publicly Traded Companies

In relevant part 18 USC §1514A provides as follows:

(a) Whistleblower Protection for Employees of Publicly Traded Companies.— No company with a class of securities registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l), or that is required to file reports under section 15(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78o (d)) including any subsidiary or affiliate whose financial information is included in the consolidated financial statements of such company, or nationally recognized statistical rating organization (as defined in section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c), or any officer, employee, contractor, subcontractor, or agent of such company or nationally recognized statistical rating organization, may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee in the terms and conditions of employment because of any lawful act done by the employee—

(1) to provide information, cause information to be provided, or otherwise assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders, when the information or assistance is provided to or the investigation is conducted by—

(A) a Federal regulatory or law enforcement agency;

(B) any Member of Congress or any committee of Congress; or

(C) a person with supervisory authority over the employee (or such other person working for the employer who has the authority to investigate, discover, or terminate misconduct); or

(2) to file, cause to be filed, testify, participate in, or otherwise assist in a proceeding filed or about to be filed (with any knowledge of the employer) relating to an alleged violation of section 1341, 1343, 1344, or 1348, any rule or regulation of the Securities and Exchange Commission, or any provision of Federal law relating to fraud against shareholders.

(b) Enforcement Action.—

(1) In general.— A person who alleges discharge or other discrimination by any person in violation of subsection (a) may seek relief under subsection (c), by—

(A) filing a complaint with the Secretary of Labor; or

(B) if the Secretary has not issued a final decision within 180 days of the filing of the complaint and there is no showing that such delay is due to the bad faith of the claimant, bringing an action at law or equity for de novo review in the appropriate district court of the United States, which shall have jurisdiction over such an action without regard to the amount in controversy.

(2) Procedure.—

(A) In general.— An action under paragraph (1)(A) shall be governed under the rules and procedures set forth in section 42121 (b) of title 49, United States Code.

(B) Exception.— Notification made under section 42121 (b)(1) of title 49, United States Code, shall be made to the person named in the complaint and to the employer.

(C) Burdens of proof.— An action brought under paragraph (1)(B) shall be governed by the legal burdens of proof set forth in section 42121 (b) of title 49, United States Code.

(D) Statute of limitations.— An action under paragraph (1) shall be commenced not later than 180 days after the date on which the violation occurs, or after the date on which the employee became aware of the violation.

(E) Jury trial.— A party to an action brought under paragraph (1)(B) shall be entitled to trial by jury.

(c) Remedies.—

(1) In general.— An employee prevailing in any action under subsection (b)(1) shall be entitled to all relief necessary to make the employee whole.

(2) Compensatory damages.— Relief for any action under paragraph (1) shall include—

(A) reinstatement with the same seniority status that the employee would have had, but for the discrimination;

(B) the amount of back pay, with interest; and

(C) compensation for any special damages sustained as a result of the discrimination, including litigation costs, expert witness fees, and reasonable attorney fees.

(d) Rights Retained by Employee.— Nothing in this section shall be deemed to diminish the rights, privileges, or remedies of any employee under any Federal or State law, or under any collective bargaining agreement.

(e) Nonenforceability of Certain Provisions Waiving Rights and Remedies or Requiring Arbitration of Disputes.—

(1) Waiver of rights and remedies.— The rights and remedies provided for in this section may not be waived by any agreement, policy form, or condition of employment, including by a predispute arbitration agreement.

(2) Predispute arbitration agreements.— No predispute arbitration agreement shall be valid or enforceable, if the agreement requires arbitration of a dispute arising under this section.

b. Retaliation Against Informants

It is unlawful for any person to knowingly and with the intent to retaliate take any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer or proceeding any truthful information relating to the occurrence or possible occurrence of any federal offense. See 18 USC §1513 and also subsection (e).



## 8. Auditor Auditing and Nonaudit Services, and Preapproval of Services

### a. Services Outside the Scope of Practice of Auditors

In relevant part 15 USC §78j-1(a) provides that a public issuing company must have an annual audit performed by an external auditor as follows:

(a) Each audit required pursuant to this chapter of the financial statements of an issuer by a registered public accounting firm shall include, in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the Commission—

(1) procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts;

(2) procedures designed to identify related party transactions that are material to the financial statements or otherwise require disclosure therein; and

(3) an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year.

The external auditor is subject to independence requirements. Accordingly, 15 USC §§78j-1(g) and (h) provide as follows:

#### (g) Prohibited activities

Except as provided in subsection (h) of this section, it shall be unlawful for a registered public accounting firm (and any associated person of that firm, to the extent determined appropriate by the Commission) that performs for any issuer any audit required by this chapter or the rules of the Commission under this chapter or, beginning 180 days after the date of commencement of the operations of the Public Company Accounting Oversight Board established under section 7211 of this title (in this section referred to as the “Board”), the rules of the Board, to provide to that issuer, contemporaneously with the audit, any non-audit service, including—

(1) bookkeeping or other services related to the accounting records or financial statements of the audit client;

(2) financial information systems design and implementation;

(3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;

(4) actuarial services;

(5) internal audit outsourcing services;

(6) management functions or human resources;

(7) broker or dealer, investment adviser, or investment banking services;

(8) legal services and expert services unrelated to the audit; and

(9) any other service that the Board determines, by regulation, is impermissible.

(h) Preapproval required for non-audit services

A registered public accounting firm may engage in any non-audit service, including tax services, that is not described in any of paragraphs (1) through (9) of subsection (g) of this section for an audit client, only if the activity is approved in advance by the audit committee of the issuer, in accordance with subsection (i) of this section.

b. Preapproval Requirements

In addition to 15 USC §§78j-1(g) and (h) that are discussed immediately above, 15 USC §78j-1(i) provides as follows:

(i) Preapproval requirements

(1) In general

(A) Audit committee action

All auditing services (which may entail providing comfort letters in connection with securities underwritings or statutory audits required for insurance companies for purposes of State law) and non-audit services, other than as provided in subparagraph (B), provided to an issuer by the auditor of the issuer shall be preapproved by the audit committee of the issuer.

(B) De minimis exception

The preapproval requirement under subparagraph (A) is waived with respect to the provision of non-audit services for an issuer, if—

(i) the aggregate amount of all such non-audit services provided to the issuer constitutes not more than 5 percent of the total amount of revenues paid by the issuer to its auditor during the fiscal year in which the non-audit services are provided;

(ii) such services were not recognized by the issuer at the time of the engagement to be non-audit services; and

(iii) such services are promptly brought to the attention of the audit committee of the issuer and approved prior to the completion of the audit by the audit committee or by 1 or more members of the audit committee who are members of the board of directors to whom authority to grant such approvals has been delegated by the audit committee.

(2) Disclosure to investors

Approval by an audit committee of an issuer under this subsection of a non-audit service to be performed by the auditor of the issuer shall be disclosed to investors in periodic reports required by section 78m(a) of this title.

(3) Delegation authority

The audit committee of an issuer may delegate to 1 or more designated members of the audit committee who are independent directors of the board of directors, the authority to grant preapprovals required by this subsection. The decisions of any member to whom authority is delegated under this paragraph to preapprove an activity under this subsection shall be presented to the full audit committee at each of its scheduled meetings.

(4) Approval of audit services for other purposes

In carrying out its duties under subsection (m)(2) of this section, if the audit committee of an issuer approves an audit service within the scope of the engagement of the auditor, such audit service shall be deemed to have been preapproved for purposes of this subsection.

c. Audit Partner Rotation

Pursuant to 15 USC §78j-1(j), it shall be 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 5 previous fiscal years of that issuer.

d. Auditor Report to Audit Committees

In relevant part 15 USC §78j-1(k) provides as follows:

Each registered public accounting firm that performs for any issuer any audit required by this chapter shall timely report to the audit committee of the issuer—

- (1) all critical accounting policies and practices to be used;
- (2) all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management officials of the issuer, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm; and
- (3) other material written communications between the registered public accounting firm and the management of the issuer, such as any management letter or schedule of unadjusted differences.

e. Conflicts of Interest

Pursuant to 15 USC §78j-1(l), it shall be unlawful for a registered public accounting firm to perform for an issuer any audit service required by this chapter, if a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit.

#### f. Unlawful Acts Discovered During Audit

In relevant part, 15 USC §78j-1(b) provides specific additional procedures as follows if during the course of an audit the external auditor detects or otherwise become aware that an illegal act has or may have occurred:

##### (b) Required response to audit discoveries

##### (1) Investigation and report to management

If, in the course of conducting an audit pursuant to this chapter to which subsection (a) of this section applies, the registered public accounting firm detects or otherwise becomes aware of information indicating that an illegal act (whether or not perceived to have a material effect on the financial statements of the issuer) has or may have occurred, the firm shall, in accordance with generally accepted auditing standards, as may be modified or supplemented from time to time by the Commission—

##### (A)

(i) determine whether it is likely that an illegal act has occurred; and

(ii) if so, determine and consider the possible effect of the illegal act on the financial statements of the issuer, including any contingent monetary effects, such as fines, penalties, and damages; and

(B) as soon as practicable, inform the appropriate level of the management of the issuer and assure that the audit committee of the issuer, or the board of directors of the issuer in the absence of such a committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of such firm in the course of the audit, unless the illegal act is clearly inconsequential.

##### (2) Response to failure to take remedial action

If, after determining that the audit committee of the board of directors of the issuer, or the board of directors of the issuer in the absence of an audit committee, is adequately informed with respect to illegal acts that have been detected or have otherwise come to the attention of the firm in the course of the audit of such firm, the registered public accounting firm concludes that—

(A) the illegal act has a material effect on the financial statements of the issuer;

(B) the senior management has not taken, and the board of directors has not caused senior management to take, timely and appropriate remedial actions with respect to the illegal act; and

(C) the failure to take remedial action is reasonably expected to warrant departure from a standard report of the auditor, when made, or warrant resignation from the audit engagement; the registered public accounting firm shall, as soon as practicable, directly report its conclusions to the board of directors.

(3) Notice to Commission; response to failure to notify

An issuer whose board of directors receives a report under paragraph (2) shall inform the Commission by notice not later than 1 business day after the receipt of such report and shall furnish the registered public accounting firm making such report with a copy of the notice furnished to the Commission. If the registered public accounting firm fails to receive a copy of the notice before the expiration of the required 1-business-day period, the registered public accounting firm shall—

(A) resign from the engagement; or

(B) furnish to the Commission a copy of its report (or the documentation of any oral report given) not later than 1 business day following such failure to receive notice.

(4) Report after resignation

If a registered public accounting firm resigns from an engagement under paragraph (3)(A), the firm shall, not later than 1 business day following the failure by the issuer to notify the Commission under paragraph (3), furnish to the Commission a copy of the report of the firm (or the documentation of any oral report given).

B. Stock Exchange (SRO) Rules

1. NYSE Listed Company Manual, <http://nysemanual.nyse.com/lcm/>

a. Audit Committee Additional Requirements

New York Stock Exchange Listed Company Manual section 303A.07, Audit Committee Additional Requirements

(b) New York Stock Exchange Listed Company Manual section 303A.07(b) The audit committee must have a written charter that addresses:

(i) the committee's purpose - which, at minimum, must be to:

(A) assist board oversight of (1) the integrity of the listed company's financial statements, (2) the listed company's compliance with legal and regulatory requirements, (3) the independent

auditor's qualifications and independence, and (4) the performance of the listed company's internal audit function and independent auditors (if the listed company does not yet have an internal audit function because it is availing itself of a transition period pursuant to Section 303A.00, the charter must provide that the committee will assist board oversight of the design and implementation of the internal audit function); and

(B) prepare the disclosure required by Item 407(d)(3)(i) of Regulation S-K;

(ii) an annual performance evaluation of the audit committee; and

(iii) the duties and responsibilities of the audit committee - which, at a minimum, must include those set out in Rule 10A-3(b)(2), (3), (4) and (5) of the Exchange Act , as well as to:

(A) at least annually, obtain and review a report by the independent auditor describing: the firm'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 preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor's independence) all relationships between the independent auditor and the listed company;

*Commentary:* After reviewing the foregoing report and the independent auditor's work throughout the year, the audit committee will be in a position to evaluate the auditor's qualifications, performance and independence. This evaluation should include the review and evaluation of the lead partner of the independent auditor. In making its evaluation, the audit committee should take into account the opinions of management and the listed company's internal auditors (or other personnel responsible for the internal audit function). In addition to assuring the regular rotation of the lead audit partner as required by law, the audit committee should further consider whether, in order to assure continuing auditor independence, there should be regular rotation of the audit firm itself. The audit committee should present its conclusions with respect to the independent auditor to the full board.

(B) meet to review and discuss the listed company's annual audited financial statements and quarterly financial statements with management and the independent auditor, including reviewing the listed company's specific disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations";

*Commentary:* Meetings may be telephonic if permitted under applicable corporate law; polling of audit committee members, however, is not permitted in lieu of meetings.

With respect to closed-end funds, Section 303A.07(b)(iii)(B) requires that the audit committee meet to review and discuss the fund's annual audited financial statements and semi-annual financial statements. In addition, if a closed-end fund chooses to voluntarily include the section "Management's Discussion of Fund Performance" in its Form N-CSR, then the audit committee is required to meet to review and discuss it.

(C) discuss the listed company's earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies;

*Commentary:* The audit committee's responsibility to discuss earnings releases, as well as financial information and earnings guidance, may be done generally (i.e., discussion of the types of information to be disclosed and the type of presentation to be made). The audit committee need not discuss in advance each earnings release or each instance in which a listed company may provide earnings guidance.

(D) discuss policies with respect to risk assessment and risk management;

*Commentary:* While it is the job of the CEO and senior management to assess and manage the listed company's exposure to risk, the audit committee must discuss guidelines and policies to govern the process by which this is handled. The audit committee should discuss the listed company's major financial risk exposures and the steps management has taken to monitor and control such exposures. The audit committee is not required to be the sole body responsible for risk assessment and management, but, as stated above, the committee must discuss guidelines and policies to govern the process by which risk assessment and management is undertaken. Many companies, particularly financial companies, manage and assess their risk through mechanisms other than the 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 by the audit committee.

(E) meet separately, periodically, with management, with internal auditors (or other personnel responsible for the internal audit function) and with independent auditors;

*Commentary:* To perform its oversight functions most effectively, the audit committee must have the benefit of separate sessions with management, the independent auditors and those responsible for the internal audit function. As noted herein, all listed companies must have an internal audit function. These separate sessions may be more productive than joint sessions in surfacing issues warranting committee attention. If the listed company does not yet have an internal audit function because it is availing itself of a transition period pursuant to Section 303A.00, the committee must meet periodically with the company personnel primarily responsible for the design and implementation of the internal audit function.

(F) review with the independent auditor any audit problems or difficulties and management's response;

*Commentary:* The audit committee must regularly review with the independent auditor any difficulties the auditor encountered in the course of the audit work, including any restrictions on the scope of the independent auditor's activities or on access to requested information, and any significant disagreements with management. Among the items the audit committee may want to review with the auditor are: any accounting adjustments that were noted or proposed by the auditor but were "passed" (as immaterial or otherwise); any communications between the audit team and the audit firm's national office respecting auditing or accounting issues presented by the engagement; and any "management" or "internal control" letter issued, or proposed to be

issued, by the audit firm to the listed company. The review should also include discussion of the responsibilities, budget and staffing of the listed company's internal audit function. If the listed company does not yet have an internal audit function because it is availing itself of a transition period pursuant to Section 303A.00, the review should include discussion of management's plans with respect to the responsibilities, budget and staffing of the internal audit function and its plans for the implementation of the internal audit function.

(G) set clear hiring policies for employees or former employees of the independent auditors; and

*Commentary:* Employees or former employees of the independent auditor are often valuable additions to corporate management. Such individuals' familiarity with the business, and personal rapport with the employees, may be attractive qualities when filling a key opening. However, the audit committee should set hiring policies taking into account the pressures that may exist for auditors consciously or subconsciously seeking a job with the listed company they audit.

(H) report regularly to the board of directors.

*Commentary:* The audit committee should review with the full board any issues that arise with respect to the quality or integrity of the listed company's financial statements, the listed company's compliance with legal or regulatory requirements, the performance and independence of the listed company's independent auditors, or the performance of the internal audit function. If the listed company does not yet have an internal audit function because it is availing itself of a transition period pursuant to Section 303A.00, the committee should review with the board management's activities with respect to the design and implementation of the internal audit function.

*General Commentary to Section 303A.07(b):* While the fundamental responsibility for the listed company's financial statements and disclosures rests with management and the independent auditor, the audit committee must review: (A) major issues regarding accounting principles and financial statement presentations, including any significant changes in the listed company's selection or application of accounting principles, and major issues as to the adequacy of the listed company's internal controls and any special audit steps adopted in light of material control deficiencies; (B) analyses prepared by management and/or the independent auditor setting forth significant financial reporting issues and judgments made in connection with the preparation of the financial statements, including analyses of the effects of alternative GAAP methods on the financial statements; (C) the effect of regulatory and accounting initiatives, as well as off-balance sheet structures, on the financial statements of the listed company; and (D) the type and presentation of information to be included in earnings press releases (paying particular attention to any use of "pro forma," or "adjusted" non-GAAP, information), as well as review any financial information and earnings guidance provided to analysts and rating agencies.

*Website Posting Requirement:* A listed company must make its audit committee charter available on or through its website. A closed-end fund is not required to comply with this website posting requirement.



*Disclosure Requirements:* A listed company must disclose in its annual proxy statement or, if it does not file an annual proxy statement, in its annual report on Form 10-K filed with the SEC that its audit committee charter is available on or through its website and provide the website address.

(c) Each listed company must have an internal audit function.

*Commentary:* Listed companies must maintain an internal audit function to provide management and the audit committee with ongoing assessments of the listed company's risk management processes and system of internal control. A listed company may choose to outsource this function to a third party service provider other than its independent auditor. While Section 303A.00 permits certain categories of newly-listed companies to avail themselves of a transition period to comply with the internal audit function requirement, all listed companies must have an internal audit function in place no later than the first anniversary of the company's listing date.

*General Commentary to Section 303A.07:* To avoid any confusion, note that the audit committee functions specified in Section 303A.07 are the sole responsibility of the audit committee and may not be allocated to a different committee.

#### b. Executive Sessions of Non-Management Directors

##### New York Stock Exchange Listed Company Manual section 303A.03, Executive Sessions

To empower non-management directors to serve as a more effective check on management, the non-management directors of each listed company must meet at regularly scheduled executive sessions without management.

*Commentary:* To promote open discussion among the non-management directors, companies must schedule regular executive sessions in which those directors meet without management participation. "Non-management" directors are all those who are not executive officers, and includes such directors who are not independent by virtue of a material relationship, former status or family membership, or for any other reason.

Regular scheduling of such meetings is important not only to foster better communication among non-management directors, but also to prevent any negative inference from attaching to the calling of executive sessions. A non-management director must preside over each executive session, although the same director is not required to preside at all executive sessions.

While this Section 303A.03 refers to meetings of non-management directors, listed companies may instead choose to hold regular executive sessions of independent directors only. An independent director must preside over each executive session of the independent directors, although the same director is not required to preside at all executive sessions of the independent directors.

If a listed company chooses to hold regular meetings of all non-management directors, such listed company should hold an executive session including only independent directors at least once a year.

*Disclosure Requirements:* If one director is chosen to preside at all of these executive sessions, his or her name must be disclosed either on or through the listed company's website or in its annual proxy statement or, if the listed company does not file an annual proxy statement, in its annual report on Form 10-K filed with the SEC. If this disclosure is made on or through the listed company's website, the listed company must disclose that fact in its annual proxy statement or annual report, as applicable, and provide the website address. Alternatively, if the same individual is not the presiding director at every meeting, a listed company must disclose the procedure by which a presiding director is selected for each executive session. For example, a listed company may wish to rotate the presiding position among the chairs of board committees.

In order that all interested parties (not just shareholders) may be able to make their concerns known to the non-management or independent directors, a listed company must also disclose a method for such parties to communicate directly with the presiding director or with those directors as a group either on or through the listed company's website or in its annual proxy statement or, if the listed company does not file an annual proxy statement, in its annual report on Form 10-K filed with the SEC. If this disclosure is made on or through the listed company's website, the listed company must disclose that fact in its annual proxy statement or annual report, as applicable, and provide the website address. Companies may, if they wish, utilize for this purpose the same procedures they have established to comply with the requirement of Rule 10A-3 (b)(3) under the Exchange Act regarding complaints to the audit committee, as applied to listed companies through Section 303A.06.

2. NASDAQ Stock Market Rules, <http://nasdaq.cchwallstreet.com/>

a. Audit Committee Charter

Nasdaq Stock Market Manual Rule 5605(c)(1), Audit Committee Charter, provides as follows:

(c) Audit Committee Requirements

(1) Audit Committee Charter

Each Company must certify that it has adopted a formal written audit committee charter and that the audit committee will review and reassess the adequacy of the formal written charter on an annual basis. The charter must specify:

(A) the scope of the audit committee's responsibilities, and how it carries out those responsibilities, including structure, processes and membership requirements;

(B) the audit committee's responsibility for ensuring its receipt from the outside auditors of a formal written statement delineating all relationships between the auditor and the Company, actively engaging in a dialogue with the auditor with respect to any disclosed relationships or services that may impact the objectivity and independence of the auditor and for taking, or recommending that the full board take, appropriate action to oversee the independence of the outside auditor;

(C) the committee's purpose of overseeing the accounting and financial reporting processes of the Company and the audits of the financial statements of the Company; and

(D) the specific audit committee responsibilities and authority set forth in Rule 5605(c)(3).

#### IM-5605-3. Audit Committee Charter

Each Company is required to adopt a formal written charter that specifies the scope of its responsibilities and the means by which it carries out those responsibilities; the outside auditor's accountability to the audit committee; and the audit committee's responsibility to ensure the independence of the outside auditor. Consistent with this, the charter must specify all audit committee responsibilities set forth in Rule 10A-3(b)(2), (3), (4) and (5) under the Act. Rule 10A-3(b)(3)(ii) under the Act requires that each audit committee must establish procedures for the confidential, anonymous submission by employees of the listed Company of concerns regarding questionable accounting or auditing matters. The rights and responsibilities as articulated in the audit committee charter empower the audit committee and enhance its effectiveness in carrying out its responsibilities.

Rule 5605(c)(3) imposes additional requirements for investment company audit committees that must also be set forth in audit committee charters for these Companies.

#### b. Audit Committee Responsibilities and Authority

Nasdaq Stock Market Manual Rule 5605(c)(3), Audit Committee Responsibilities and Authority, provides as follows:

##### (3) Audit Committee Responsibilities and Authority

The audit committee must have the specific audit committee responsibilities and authority necessary to comply with Rule 10A-3(b)(2), (3), (4) and (5) under the Act (subject to the exemptions provided in Rule 10A-3(c) under the Act), concerning responsibilities relating to: (i) registered public accounting firms, (ii) complaints relating to accounting, internal accounting controls or auditing matters, (iii) authority to engage advisers, and (iv) funding as determined by the audit committee. Audit committees for investment companies must also establish procedures for the confidential, anonymous submission of concerns regarding questionable accounting or auditing matters by employees of the investment adviser, administrator, principal underwriter, or any other provider of accounting related services for the investment company, as well as employees of the investment company.

#### IM-5605-5. The Audit Committee Responsibilities and Authority

Audit committees must have the specific audit committee responsibilities and authority necessary to comply with Rule 10A-3(b)(2), (3), (4) and (5) under the Act (subject to the exemptions provided in Rule 10A-3(c) under the Act), concerning responsibilities relating to registered public accounting firms; complaints relating to accounting; internal accounting controls or auditing matters; authority to engage advisers; and funding. Audit committees for

investment companies must also establish procedures for the confidential, anonymous submission of concerns regarding questionable accounting or auditing matters by employees of the investment adviser, administrator, principal underwriter, or any other provider of accounting related services for the investment company, as well as employees of the investment company.

#### c. Independent Directors and Executive Sessions

Nasdaq Stock Market Manual Rule 5605(b)(2), Executive Sessions, provides as follows:

##### (2) Executive Sessions

Independent Directors must have regularly scheduled meetings at which only Independent Directors are present ("executive sessions").

##### IM-5605-2. Executive Sessions of Independent Directors

Regularly scheduled executive sessions encourage and enhance communication among Independent Directors. It is contemplated that executive sessions will occur at least twice a year, and perhaps more frequently, in conjunction with regularly scheduled board meetings.

#### d. Conflicts of Interest

Nasdaq Stock Market Manual Rule 5630, Review of Related Party Transactions, provides as follows:

##### 5630. Review of Related Party Transactions

(a) Each Company that is not a limited partnership shall conduct an appropriate review and oversight of all related party transactions for potential conflict of interest situations on an ongoing basis by the Company's audit committee or another independent body of the board of directors. For purposes of this rule, the term "related party transaction" shall refer to transactions required to be disclosed pursuant to Item 404 of Regulation S-K under the Act. However, in the case of non-U.S. issuers, the term "related party transactions" shall refer to transactions required to be disclosed pursuant to Form 20-F, Item 7.B.

(b) Limited partnerships shall comply with the requirements of Rule 5615(a)(4)(G).

#### e. Code of Conduct

Nasdaq Stock Market Manual Rule 5610, Code of Conduct, provides as follows:

##### 5610. Code of Conduct

Each Company shall adopt a code of conduct applicable to all directors, officers and employees, which shall be publicly available. A code of conduct satisfying this rule must comply with the definition of a "code of ethics" set out in Section 406(c) of the Sarbanes-Oxley Act of 2002 ("the Sarbanes-Oxley Act") and any regulations promulgated thereunder by the Commission. See 17 C.F.R. 228.406 and 17 C.F.R. 229.406. In addition, the code must provide for an enforcement

mechanism. Any waivers of the code for directors or Executive Officers must be approved by the Board. Companies, other than Foreign Private Issuers, shall disclose such waivers within four business days by filing a current report on Form 8-K with the Commission or, in cases where a Form 8-K is not required, by distributing a press release. Foreign Private Issuers shall disclose such waivers either by distributing a press release or including disclosure in a Form 6-K or in the next Form 20-F or 40-F. Alternatively, a Company, including a Foreign Private Issuer, may disclose waivers on the Company's website in a manner that satisfies the requirements of Item 5.05(c) of Form 8-K.

#### IM-5610. Code of Conduct

Ethical behavior is required and expected of every corporate director, officer and employee whether or not a formal code of conduct exists. The requirement of a publicly available code of conduct applicable to all directors, officers and employees of a Company is intended to demonstrate to investors that the board and management of Nasdaq Companies have carefully considered the requirement of ethical dealing and have put in place a system to ensure that they become aware of and take prompt action against any questionable behavior. For Company personnel, a code of conduct with enforcement provisions provides assurance that reporting of questionable behavior is protected and encouraged, and fosters an atmosphere of self-awareness and prudent conduct.

Rule 5610 requires Companies to adopt a code of conduct complying with the definition of a "code of ethics" under Section 406(c) of the Sarbanes-Oxley Act of 2002 ("the Sarbanes-Oxley Act") and any regulations promulgated thereunder by the Commission. See 17 C.F.R. 228.406 and 17 C.F.R. 229.406. Thus, the code must include such standards as are reasonably necessary to promote the ethical handling of conflicts of interest, full and fair disclosure, and compliance with laws, rules and regulations, as specified by the Sarbanes-Oxley Act. However, the code of conduct required by Rule 5610 must apply to all directors, officers, and employees. Companies can satisfy this obligation by adopting one or more codes of conduct, such that all directors, officers and employees are subject to a code that satisfies the definition of a "code of ethics."

As the Sarbanes-Oxley Act recognizes, investors are harmed when the real or perceived private interest of a director, officer or employee is in conflict with the interests of the Company, as when the individual receives improper personal benefits as a result of his or her position with the Company, or when the individual has other duties, responsibilities or obligations that run counter to his or her duty to the Company. Also, the disclosures a Company makes to the Commission are the essential source of information about the Company for regulators and investors — there can be no question about the duty to make them fairly, accurately and timely. Finally, illegal action must be dealt with swiftly and the violators reported to the appropriate authorities. Each code of conduct must require that any waiver of the code for Executive Officers or directors may be made only by the board and must be disclosed to Shareholders, along with the reasons for the waiver. All Companies, other than Foreign Private Issuers, must disclose such waivers within four business days by filing a current report on Form 8-K with the Commission, providing website disclosure that satisfies the requirements of Item 5.05(c) of Form 8-K, or, in cases where a Form 8-K is not required, by distributing a press release. Foreign Private Issuers must disclose such waivers either by providing website disclosure that satisfies the requirements of Item

5.05(c) of Form 8-K, by including disclosure in a Form 6-K or in the next Form 20-F or 40-F or by distributing a press release. This disclosure requirement provides investors the comfort that waivers are not granted except where they are truly necessary and warranted, and that they are limited and qualified so as to protect the Company and its Shareholders to the greatest extent possible.

Each code of conduct must also contain an enforcement mechanism that ensures prompt and consistent enforcement of the code, protection for persons reporting questionable behavior, clear and objective standards for compliance, and a fair process by which to determine violations.

[Hyperlink Back to Main Table of Contents](#)

## **VI. AUDITS, REVIEWS AND COMPILATIONS**

### **A. Audits**

#### **1. Overview**

How to perform an audit is outside the scope of this paper. I am assuming that someone who serves on an audit committee is sufficiently knowledgeable about how an audit is performed. However, the following discussion from auditing pronouncements (Statements on Auditing Standards (SAS) 122/123, AU-C 200) in relevant part do a good job of describing an audit of financial statements. Statements on Auditing Standards are prepared by the American Institute of Certified Public Accountants (“AICPA”). These are the standards for the actions that are taken by the external auditors when they are performing an audit engagement. These standards, or at least some of them are important to audit committees because an audit committee member needs to know what tasks or procedures the external auditor is required to perform or accomplish when performing the engagement for which the external auditor has been hired.

The purpose of an audit is to provide financial statement users with an opinion by the auditor on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework, which enhances the degree of confidence that intended users can place in the financial statements. An audit conducted in accordance with generally accepted auditing standards (GAAS) and relevant ethical requirements enables the auditor to form that opinion.

The financial statements subject to audit are those of the entity, prepared and presented by management of the entity with oversight from those charged with governance. GAAS do not impose responsibilities on management or those charged with governance and do not override laws and regulations that govern their responsibilities. However, an audit in accordance with GAAS is conducted on the premise that management and, when appropriate, those charged with governance have acknowledged certain responsibilities that are fundamental to the conduct of the audit. The audit of the financial statements does not relieve management or those charged with governance of their responsibilities.

As the basis for the auditor's opinion, GAAS require the auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement,

whether due to fraud or error. Reasonable assurance is a high, but not absolute, level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level. Reasonable assurance is not an absolute level of assurance because there are inherent limitations of an audit that result in most of the audit evidence, on which the auditor draws conclusions and bases the auditor's opinion, being persuasive rather than conclusive.

The concept of materiality is applied by the auditor when both planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and uncorrected misstatements, if any, on the financial statements. <sup>1</sup> In general, misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users that are taken based on the financial statements. Judgments about materiality are made in light of surrounding circumstances, and involve both qualitative and quantitative considerations. These judgments are affected by the auditor's perception of the financial information needs of users of the financial statements, and by the size or nature of a misstatement, or both. The auditor's opinion addresses the financial statements as a whole. Therefore, the auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by fraud or error, that are not material to the financial statements as a whole, are detected.

GAAS contain objectives, requirements, and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. GAAS require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things,

- identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control.
- obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
- form an opinion on the financial statements, or determine that an opinion cannot be formed, based on an evaluation of the audit evidence obtained.

The form of opinion expressed by the auditor will depend upon the applicable financial reporting framework and any applicable law or regulation.

The auditor also may have certain other communication and reporting responsibilities to users, management, those charged with governance, or parties outside the entity, regarding matters arising from the audit. These responsibilities may be established by GAAS or by applicable law or regulation.

The overall objectives of the auditor, in conducting an audit of financial statements, are to

a. obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are presented fairly, in all material respects, in accordance with an applicable financial reporting framework; and

b. report on the financial statements, and communicate as required by GAAS, in accordance with the auditor's findings.

In all cases when reasonable assurance cannot be obtained and a qualified opinion in the auditor's report is insufficient in the circumstances for purposes of reporting to the intended users of the financial statements, GAAS require that the auditor disclaim an opinion or withdraw from the engagement, when withdrawal is possible under applicable law or regulation.

There are many GAAS pronouncements that apply during the course of an audit. You can see lists of Statements on Auditing Standards and links to some of their provisions on the following websites:

AICPA, <http://www.aicpa.org/Research/Standards/AuditAttest/Pages/SAS.aspx>,  
<http://www.aicpa.org/INTERESTAREAS/FRC/AUDITATTEST/Pages/AuditAttestServices.aspx>

AICPA Auditing Standards Board website,  
<http://www.aicpa.org/Research/Standards/AuditAttest/ASB/Pages/AuditingStandardsBoard.aspx>

Statements on Auditing Standards page from Wikipedia (helpful for its links),  
[http://en.wikipedia.org/wiki/Statements\\_on\\_Auditing\\_Standards\\_\(United\\_States\)](http://en.wikipedia.org/wiki/Statements_on_Auditing_Standards_(United_States))

For the purpose of this audit committee guide and audits I discuss below Statements on Auditing Standards SAS 109 (understanding the entity and its environment and assessing risks of material misstatement), SAS 114 (auditor's communications with audit committees and those charged with governance), SAS 115 (communicating internal control 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 122 – AU-C Section 240 (consideration of fraud in a financial statement audit), in addition to SSARS 21 for performing reviews and compilations, and PCAOB AS no. 5 (An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements), and PCAOB AS no. 16 (Communications with Audit Committees).

Presently I have not discussed below SAS 107 – audit risk and materiality – however, the auditor's evaluation of audit risk and materiality is important to the audit and the audit planning process, and it is a topic that the audit committee should discuss with the external auditor. Similarly, PCAOB AS no. 12 discusses identifying and assessing risks of material misstatement. I will discuss both of these pronouncements in later editions.

2. SAS 109 – understanding the entity and its environment and assessing risks of material misstatement



Statement on Auditing Standards (SAS) 109 ("Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement") provides that during the process of an audit, the outside auditor should obtain an understanding of the five components of internal control sufficient 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. Thus, the provisions of SAS 109 are applicable for all audits, and are not limited to an evaluation of internal control under Sarbanes-Oxley Act §404 (15 USC §7262).

Statement on Auditing Standards 109 describes "internal control" as a process effected by those charged with governance, management, and other personnel—that is designed to provide reasonable assurance regarding the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control consists of five interrelated components: control environment, risk assessment, information and communication, control activities, and monitoring.

The "control environment" sets the tone of the organization and influences the control consciousness of its people. SAS 109. The primary responsibility for the prevention and detection of fraud and error rests with those charged with governance and the management of the entity. In evaluating the design of the company's control environment, the outside auditor is required to consider the entity's processes in the following areas:

- Communication and enforcement of integrity and ethical values;
- Commitment to competence;
- Participation of those charged with governance, including the audit committee and possibly the board of directors;
- Management's philosophy and operating style;
- Organizational structure;
- Assignment of authority and responsibility; and
- Human resource policies and practices.

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.

The outside auditor is required to evaluate whether a deficiency in internal control is significant enough to require communication of the deficiency to the audit committee, pursuant to

SAS 112. Additionally, SAS 109 states that a significant internal control deficiency, or a lack of appropriate corrective response by management to a material deficiency, may raise doubt about the integrity of management, and whether it is possible to audit the financial statements.

### 3. SAS 114 – auditor’s communications with audit committees and those charged with governance

Statement on Auditing Standards (SAS) 114 ("The Auditor's Communication With Those Charged With Governance") requires the external auditor to determine that certain matters relating to the audit of the financial statements are communicated to those charged with governance.

The term "those charged with governance" is defined in SAS 103, n5 and may vary from entity to entity, but it at least includes the audit committee and may include the board of directors.

Statement on Auditing Standards 114 provides that the auditor should have access to the audit committee as necessary, 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.

At least, the auditor must communicate with those charged with governance regarding the auditor's responsibilities under generally accepted auditing standards the planned scope and timing of the audit and significant findings from the audit.

In pertinent part, with respect to the planning, scope, and timing of the audit, SAS 114 provides that matters communicated may include (1) how the auditor proposes to address the significant risks of material misstatement, whether due to fraud or error; (2) the auditor's approach to internal control relevant to the audit; (3) the concept of materiality in planning and executing the audit; and (4) where the entity has an internal audit function, the extent to which the auditor will use the work of the internal audit, and how the external and internal auditors can best work together.

Other planning matters that the auditor may consider discussing with those charged with governance include the following:

#### 1. Their views about

- The appropriate people in the company's governance structure with whom to communicate;
- The allocation of responsibilities between those charged with governance and management;
- The company's objectives and strategies, and the related business risks that may result in material misstatements;
- Matters that warrant particular attention during the audit, and any areas where they request that additional procedures to be undertaken;
- Significant communications with regulators; and

- Other matters those charged with governance believe are relevant to the audit of the financial statements.

2. Their attitudes, awareness, and actions concerning the company's internal control and its importance, including how those charged with governance oversee the effectiveness of internal control and the detection or possibility of fraud.

3. Their actions in response to developments in financial reporting, laws, accounting standards, corporate governance practices, and other related matters.

4. Their actions in response to previous communications with the auditor.

According to SAS 114, the auditor should also timely communicate with those charged with governance significant findings from the audit, including, but not necessarily limited to, the following:

a. The auditor's views about the qualitative aspects of the company's accounting practices, including accounting policies and related changes, accounting estimates, and financial statement disclosures, and whether the auditor considers any significant accounting practice not to be appropriate or not to be the most appropriate under the circumstances;

b. Significant difficulties, if any, encountered during the audit, such as management delays in providing requested information, being given an unnecessarily brief time in which to complete the audit, extensive unexpected efforts required to obtain audit evidence, the unavailability of expected information, restrictions imposed on the auditor by management, and management's unwillingness to provide information;

c. Uncorrected misstatements, other than those the auditor believes are insignificant, and the implication of a failure to correct likely misstatements;

d. Any disagreements with management, whether or not satisfactorily resolved;

e. Material, corrected misstatements that were brought to the attention of management as a result of audit procedures, and other corrected misstatements, such as frequently recurring immaterial misstatements that indicate a particular bias in the preparation of the financial statements;

f. Representations the auditor is requesting from management;

g. Management's consultations with other accountants;

h. Any significant issues discussed or the subject of correspondence with management;

i. Other findings or issues, if any, arising from the audit that the auditor believes would be significant and relevant to those charged with governance; and

j. Any issues, circumstances, or relationships that the auditor believes may have some bearing on or relevance to the auditor's independence.

Statement on Auditing Standards 114 places significant emphasis on the need for mutual understanding about the process of effective two-way communications between the auditor and those charged with governance, and that those charged with governance will communicate to the auditor about matters they consider relevant to the audit including, for example, strategic decisions that may significantly affect the nature, timing, and extent of audit procedures; the suspicion or the detection of fraud; and concerns about the integrity or competence of senior management.

Statement on Auditing Standards 114 specifically states that 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, and if it has not, the auditor should take appropriate action to address the effectiveness of the communication process. Inadequate two-way communications may indicate an unsatisfactory control environment, which may influence the auditor's assessment of the risks of material misstatement. When evaluating the adequacy of two-way communication between the auditor and those charged with governance, the auditor may consider such matters as:

1. The appropriateness and timeliness of actions taken in response to matters communicated by the auditor;
2. The apparent openness of those charged with governance in their communications with the auditor;
3. Their willingness and capacity to meet with the auditor without management present;
4. Their apparent ability to fully comprehend matters communicated by the auditor, such as the extent to which they probe issues and question recommendations made to them;
5. Difficulty in establishing a mutual understanding of the form, timing, and expected general content of communications; and
6. Where all or some of those charged with governance are involved in managing the company, their apparent awareness of how matters discussed with the auditor affect their broader governance responsibilities.

Statement on Auditing Standards 114 also states that if a situation of inadequate communication with those charged with governance cannot be resolved, the auditor may take various actions including modifying the auditor's opinion on the basis of an audit scope limitation, obtaining legal advice about the consequences of different courses of action, withdrawing from the engagement, or communicating with a third party (such as a regulator or responsible government agency) or a higher authority in the company's governance structure.

4. SAS 115 – communicating internal control matters identified in an audit, is applicable for all audits and is not limited to audits performed for the purpose of Sarbanes-Oxley §404

Statement on Auditing Standards 115 defines internal control as follows:

“Internal control is a process—effected by those charged with governance, management, and other personnel—designed to provide reasonable assurance about the achievement of the entity's objectives with regard to the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. Internal control over the safeguarding of assets against unauthorized acquisition, use, or disposition may include controls related to financial reporting and operations objectives. Generally, controls that are relevant to an audit of financial statements are those that pertain to the entity's objective of reliable financial reporting. In this section, the term *financial reporting* relates to the preparation of reliable financial statements that are fairly presented in conformity with generally accepted accounting principles (GAAP). The design and formality of an entity's internal control will vary depending on the entity's size, the industry in which it operates, its culture, and management's philosophy.

In an audit of financial statements, the auditor is not required to perform procedures to identify deficiencies in internal control or to express an opinion on the effectiveness of the entity's internal control. However, during the course of an audit, the auditor may become aware of deficiencies in internal control while obtaining an understanding of the entity and its environment, including its internal control, assessing the risks of material misstatement of the financial statements due to error or fraud, performing further audit procedures to respond to assessed risks, communicating with management or others (for example, internal auditors or governmental authorities), or otherwise. The auditor's awareness of deficiencies in internal control varies with each audit and is influenced by the nature, timing, and extent of audit procedures performed, as well as other factors.”

As an audit committee member I am not satisfied with the above description of internal control or the discussion external auditor's identification and reporting responsibilities. Internal controls, including for example COSO 2013, are very important to the entity's operations and the audit committee or board's oversight. The external auditor does have to take internal control into consideration when planning the audit and addressing the risks of material misstatement, in addition to issues pertaining to SOX 404. As an audit committee member I want to know how the external evaluated internal control, what the external auditor evaluated (from a COSO 2013 perspective?), what the external auditor found and how the external auditor reacted thereto, and the improvements that the external auditor recommends. I believe that SAS 115 is behind the times both in terms of what I would expect as an audit committee member and what businesses and investors need.

Statement on Auditing Standards 115 provides that “Deficiencies identified during the audit that upon evaluation are considered significant deficiencies or material weaknesses under this section should be communicated, in writing, to management and those charged with governance as a part of each audit, including significant deficiencies and material weaknesses that were communicated to management and those charged with governance in previous audits and have not yet been remediated. Significant deficiencies and material weaknesses that previously were communicated and have not yet been remediated may be communicated, in writing, by referring to the previously issued written communication and

the date of that communication” Regardless of the communication timing suggested in SAS 115, as an audit committee member I want to know about significant deficiencies very promptly, in writing or otherwise. Communications on these issues can be confirmed in writing later.

“Nothing precludes the auditor from communicating to management and those charged with governance other matters related to an entity's internal control. For example, the auditor may communicate matters the auditor believes to be of potential benefit to the entity, such as recommendations for operational or administrative efficiency, or for improving controls, and deficiencies that are not significant deficiencies or material weaknesses.”

Statement on Auditing Standards 115 provides:

“The written communication regarding significant deficiencies and material weaknesses identified during the audit of financial statements should

- include a statement that indicates the purpose of the auditor's consideration of internal control was to express an opinion on the financial statements, but not to express an opinion on the effectiveness of the entity's internal control.
- include a statement that indicates the auditor is not expressing an opinion on the effectiveness of internal control.
- include a statement that indicates that the auditor's consideration of internal control was not designed to identify all deficiencies in internal control that might be significant deficiencies or material weaknesses.
- include the definition of the term material weakness and, where relevant, the definition of the term significant deficiency.
- identify the matters that are considered to be significant deficiencies and those that are considered to be material weaknesses.
- include a statement that indicates the communication is intended solely for the information and use of management, those charged with governance, and others within the organization and is not intended to be and should not be used by anyone other than these specified parties. If an entity is required to furnish such auditor communications to a governmental authority, specific reference to such governmental authorities may be made.”

Audit committee members should be familiar with SAS 115.

## 5. SAS 122 – AU-C Section 240 Consideration of Fraud in a Financial Statement Audit

Misstatements in the financial statements can arise from either fraud (intentional actions) or error (unintentional actions). “Fraud” is a legal concept that can have differing definitions. But for the purpose of these materials we are not going to get into the legal distinctions. Pursuant to Statement on Auditing Standards SAS 122, for the purposes of generally accepted auditing standards, “the auditor is primarily concerned with fraud that causes a material misstatement in the financial statements. Two types of intentional misstatements are relevant to the auditor – misstatements resulting from fraudulent financial

reporting and misstatements resulting from misappropriation of assets. Although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred.”

Statement on Auditing Standards 122 further provides “The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. It is important that management, with the oversight of those charged with governance, places a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment. This involves a commitment to creating a culture of honesty and ethical behavior, which can be reinforced by active oversight by those charged with governance. Oversight by those charged with governance includes considering the potential for override of controls or other inappropriate influence over the financial reporting process, such as efforts by management to manage earnings in order to influence the perceptions of financial statement users regarding the entity's performance and profitability. \* \* \* \* An auditor conducting an audit in accordance with GAAS is responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error. Due to the inherent limitations of an audit, an unavoidable risk exists that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with GAAS.”

The objectives of the auditor are to (a) identify and assess the risks of material misstatement of the financial statements due to fraud; (b) obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and (c) respond appropriately to fraud or suspected fraud identified during the audit.

Relevant to the purpose of the discussion in these materials, in pertinent part SAS 122 provides:

The auditor should make inquiries of management regarding:

- (a) Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent, and frequency of such assessments;
- (b) Management's process for identifying, responding to, and monitoring the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist;
- (c) Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and
- (d) Management's communication, if any, to employees regarding its views on business practices and ethical behavior.

Statement on Auditing Standards 122 further provides that the auditor should make

inquiries of management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected, or alleged fraud affecting the entity.

“For those entities that have an internal audit function, the auditor should make inquiries of internal audit to obtain its views about the risks of fraud; determine whether it has knowledge of any actual, suspected, or alleged fraud affecting the entity; whether it has performed any procedures to identify or detect fraud during the year; and whether management has satisfactorily responded to any findings resulting from these procedures.”

“Unless all of those charged with governance are involved in managing the entity, the auditor should obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud in the entity and the internal control that management has established to mitigate these risks.”

“Unless all of those charged with governance are involved in managing the entity, the auditor should make inquiries of those charged with governance (or the audit committee or, at least, its chair) to determine their views about the risks of fraud and whether they have knowledge of any actual, suspected, or alleged fraud affecting the entity. These inquiries are made, in part, to corroborate the responses received from the inquiries of management.”

In relevant part, SAS 122 also discusses the auditor's responsibility to evaluate whether unusual or unexpected relationships that have been identified indicate risks of material misstatement due to fraud.

#### 6. PCAOB AS no. 5 – An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements

Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 5 ("An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements") applies to an audit of internal control, such as one performed under Sarbanes-Oxley Act §404 (15 USC §7262), but does not otherwise apply generally with respect to an audit of the financial statements where internal controls are evaluated for the purpose of planning the audit, materiality and testing, but not for the purpose of issuing a specific opinion about the effectiveness of the internal controls.

These are complicated topics that seem to be becoming more complicated and detailed and are also covered in standalone publications. See also the discussion in these materials at part V regarding Management Assessment of Internal Controls, SEC Release Nos. 33-8238 and 34-47986 at <http://www.sec.gov/rules/final/33-8238.htm>, PCAOB AS 5, An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements at part VI of these materials and at [http://pcaobus.org/Standards/Auditing/Pages/Auditing\\_Standard\\_5.aspx](http://pcaobus.org/Standards/Auditing/Pages/Auditing_Standard_5.aspx), and AU Section 325 Communications About Control Deficiencies in an Audit of Financial Statements at <http://pcaobus.org/standards/auditing/pages/au325b.aspx>.



Auditing Standard No. 5 states (see 111121-24) that the 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. Company-level controls include the following:

- Controls related to the control environment;
- Controls over management overrides;
- The company's risk assessment process;
- Centralized processing and controls;
- Controls to monitor results of operations;
- Controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment program;
- Controls over the period-end financial reporting process; and
- Policies that address significant business control and risk management practices.

Paragraph 25 provides that as part of evaluating the control environment, the auditor should assess

- Whether management's philosophy and operating style promote effective internal control over financial reporting;
- Whether sound integrity and ethical values, particularly of top management, are developed and understood; and
- Whether the board or audit committee understands and exercises oversight responsibilities over financial reporting and internal controls.

Paragraph 69 states that indicators of material weakness in internal control over financial reporting include

- Identification of fraud by senior management, whether or not material;
- Restatement of previously issued financial statements;
- Identification by the outside auditor of a material misstatement in the current period in circumstances that indicate the misstatement would not have been detected by the company's internal control over financial reporting; and
- Ineffective oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee.

Paragraphs 78 and 80-81 state that the outside auditor must communicate in writing to management and the audit committee all deficiencies, significant deficiencies, and material weaknesses, and combinations thereof, in internal control over financial reporting identified during the audit. The communication should be made before the issuance of the report on internal control over financial reporting.

Paragraph 79 states that if the auditor concludes the oversight of the company's external financial reporting and internal control over financial reporting by the company's audit committee is ineffective, then the auditor must communicate that conclusion in writing to the board of directors.

Appendix A, 11A3 of Auditing Standard No. 5 defines the term "deficiency in internal control."

Appendix A, 11A5 of Auditing Standard No. 5 defines the term "internal control over financial reporting." See also, Securities Exchange Act Rules 13a-15(f) and 15d-15(f) (17 CFR §§240.13a-15(f) and 240.15d-15(f)).

Appendix A, 11A6 of Auditing Standard No. 5 defines the term "management's assessment." See also, 17 CFR §§228.308(a)(3) and 229.308(a)(3).

Appendix A, 11A7 of Auditing Standard No. 5 defines the term "material weakness." Paragraph A7 further states that there is a reasonable possibility of the occurrence of an event when the likelihood of the event is either "reasonably possible" or "probable," as those terms are defined in Financial Accounting Standards Board Statement 5.

Appendix A, IIA10 of Auditing Standard No. 5 defines the term "significant account."

Appendix A, ¶A11 of Auditing Standard No. 5 defines the term "significant deficiency."

## 7. PCAOB AS no. 16 – Communications with Audit Committees

Public Company Accounting Oversight Board Auditing Standard no. 16 requires the auditor to communicate with the company's audit committee regarding certain matters related to the conduct of an audit and to obtain certain information from the audit committee relevant to the audit. Auditing Standard no. 16 also requires the auditor to establish an understanding of the terms of the audit engagement with the audit committee and to record that understanding in an engagement letter.

The following is a summary of AS no. 16. You should read and understand AS no. 16 in its entirety. You will note that AS no. 16 is very lengthy – as an audit committee member be sure that the external auditor discusses these matters with you, in addition to anything else that the auditor knows that he or she believes that you should also know about.

Pursuant to AS no. 16, the objectives of the auditor are to:

- a. Communicate to the audit committee the responsibilities of the auditor in relation to the audit and establish an understanding of the terms of the audit engagement with the audit committee;
- b. Obtain information from the audit committee relevant to the audit;
- c. Communicate to the audit committee an overview of the overall audit strategy and timing of the audit; and
- d. Provide the audit committee with timely observations arising from the audit that are significant to the financial reporting process.

Pursuant to AS no. 16, the auditor should discuss with the audit committee any significant issues that the auditor discussed with management in connection with the appointment or retention of the auditor, including significant discussions regarding the application of accounting principles and auditing standards.

The auditor should establish an understanding of the terms of the audit engagement with the audit committee. This understanding includes communicating to the audit committee the following:

- a. The objective of the audit;
- b. The responsibilities of the auditor; and
- c. The responsibilities of management.

The auditor should record the understanding of the terms of the audit engagement in an engagement letter and provide the engagement letter to the audit committee annually. The auditor should have the engagement letter executed by the appropriate party or parties on behalf of the company. Appendix C to AS no. 16 describes matters that the auditor should include in the engagement letter about the terms of the audit engagement.

The auditor should inquire of the audit committee about whether it is aware of matters relevant to the audit, including, but not limited to, violations or possible violations of laws or regulations.

The auditor should communicate to the audit committee an overview of the overall audit strategy, including the timing of the audit, and discuss with the audit committee the significant risks identified during the auditor's risk assessment procedures.

Pursuant to AS no. 16, as part of communicating the overall audit strategy, the auditor should communicate the following matters to the audit committee, if applicable:

- a. The nature and extent of specialized skill or knowledge needed to perform the planned audit procedures or evaluate the audit results related to significant risks;
- b. The extent to which the auditor plans to use the work of the company's internal auditors in an audit of financial statements;
- c. The extent to which the auditor plans to use the work of internal auditors, company personnel (in addition to internal auditors), and third parties working under the direction of management or the audit committee when performing an audit of internal control over financial reporting;
- d. The names, locations, and planned responsibilities of other independent public accounting firms or other persons, who are not employed by the auditor, that perform audit procedures in the current period audit; and
- e. The basis for the auditor's determination that the auditor can serve as principal auditor, if significant parts of the audit are to be performed by other auditors.

The term "other independent public accounting firms" in the context of AS no. 16 includes firms that perform audit procedures in the current period audit regardless of whether they otherwise have any relationship with the auditor.

The auditor should communicate to the audit committee significant changes to the planned audit strategy or the significant risks initially identified and the reasons for such changes.

Auditing Standard no. 16 further provides that the auditor should communicate to the audit committee the following matters:

- a. Significant accounting policies and practices.
  - (1) Management's initial selection of, or changes in, significant accounting policies or the application of such policies in the current period; and
  - (2) The effect on financial statements or disclosures of significant accounting policies in (i) controversial areas or (ii) areas for which there is a lack of authoritative guidance or consensus, or diversity in practice.
- b. Critical accounting policies and practices. All critical accounting policies and practices to be used, including:
  - (1) The reasons certain policies and practices are considered critical; and
  - (2) How current and anticipated future events might affect the determination of whether certain policies and practices are considered critical.

Critical accounting policies and practices, as defined in Appendix A of AS no. 16, are a company's accounting policies and practices that are both most important to the portrayal of the company's financial condition and results, and require management's most difficult, subjective, or complex judgments, often as a result of the need to make estimates about the effects of matters that are inherently uncertain. Critical accounting policies and practices are tailored to specific events in the current year, and the accounting policies and practices that are considered critical might change from year to year.

- c. Critical accounting estimates.
  - (1) A description of the process management used to develop critical accounting estimates;
  - (2) Management's significant assumptions used in critical accounting estimates that have a high degree of subjectivity; and
  - (3) Any significant changes management made to the processes used to develop critical accounting estimates or significant assumptions, a description of management's reasons for the changes, and the effects of the changes on the financial statements.
- d. Significant unusual transactions.

- (1) Significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature; and
- (2) The policies and practices management used to account for significant unusual transactions.

Auditing Standard no. 16 further provides that as part of its communications to the audit committee, management might communicate some or all of the matters in paragraph 12. If management communicates any of these matters, the auditor does not need to communicate them at the same level of detail as management, as long as the auditor (1) participated in management's discussion with the audit committee, (2) affirmatively confirmed to the audit committee that management has adequately communicated these matters, and (3) with respect to critical accounting policies and practices, identified for the audit committee those accounting policies and practices that the auditor considers critical. The auditor should communicate any omitted or inadequately described matters to the audit committee.

Auditing Standard no. 16 further provides that the auditor should communicate to the audit committee the following matters:

- a. Qualitative aspects of significant accounting policies and practices.
  - (1) The results of the auditor's evaluation of, and conclusions about, the qualitative aspects of the company's significant accounting policies and practices, including situations in which the auditor identified bias in management's judgments about the amounts and disclosures in the financial statements; and
  - (2) The results of the auditor's evaluation of the differences between (i) estimates best supported by the audit evidence and (ii) estimates included in the financial statements, which are individually reasonable, that indicate a possible bias on the part of the company's management.
- b. Assessment of critical accounting policies and practices. The auditor's assessment of management's disclosures related to the critical accounting policies and practices, along with any significant modifications to the disclosure of those policies and practices proposed by the auditor that management did not make.
- c. Conclusions regarding critical accounting estimates. The basis for the auditor's conclusions regarding the reasonableness of the critical accounting estimates.
- d. Significant unusual transactions. The auditor's understanding of the business purpose (or the lack thereof) of significant unusual transactions.
- e. Financial statement presentation. The results of the auditor's evaluation of whether the presentation of the financial statements and the related disclosures are in conformity with the applicable financial reporting framework, including the auditor's consideration of the form, arrangement, and content of the financial statements (including the accompanying notes), encompassing matters such as the terminology used, the amount of detail given, the classification of items, and the bases of amounts set forth.
- f. New accounting pronouncements. Situations in which, as a result of the auditor's procedures, the auditor identified a concern regarding management's anticipated

application of accounting pronouncements that have been issued but are not yet effective and might have a significant effect on future financial reporting.

- g. Alternative accounting treatments. All alternative treatments permissible under the applicable financial reporting framework for policies and practices related to material items that have been discussed with management, including the ramifications of the use of such alternative disclosures and treatments and the treatment preferred by the auditor.

When other information is presented in documents containing audited financial statements, the auditor should communicate to the audit committee the auditor's responsibility under PCAOB rules and standards for such information, any related procedures performed, and the results of such procedures.

The auditor should communicate to the audit committee matters that are difficult or contentious for which the auditor consulted outside the engagement team and that the auditor reasonably determined are relevant to the audit committee's oversight of the financial reporting process.

When the auditor is aware that management consulted with other accountants about significant auditing or accounting matters and the auditor has identified a concern regarding such matters, the auditor should communicate to the audit committee his or her views about such matters that were the subject of such consultation

Auditing Standard no. 16 further provides that the auditor should communicate to the audit committee, when applicable, the following matters relating to the auditor's evaluation of the company's ability to continue as a going concern:

- a. If the auditor believes there is substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, the conditions and events that the auditor identified that, when considered in the aggregate, indicate that there is substantial doubt;
- b. If the auditor concludes, after consideration of management's plans, that substantial doubt about the company's ability to continue as a going concern is alleviated, the basis for the auditor's conclusion, including elements the auditor identified within management's plans that are significant to overcoming the adverse effects of the conditions and events;
- c. If the auditor concludes, after consideration of management's plans, that substantial doubt about the company's ability to continue as a going concern for a reasonable period of time remains:
  - (1) The effects, if any, on the financial statements and the adequacy of the related disclosure; and
  - (2) The effects on the auditor's report.

The auditor should provide the audit committee with the schedule of uncorrected misstatements related to accounts and disclosures that the auditor presented to management. The auditor should discuss with the audit committee, or determine that management has adequately discussed with the audit committee, the basis for the determination that the uncorrected misstatements were immaterial, including the qualitative factors considered. The auditor also

should communicate that uncorrected misstatements or matters underlying those uncorrected misstatements could potentially cause future-period financial statements to be materially misstated, even if the auditor has concluded that the uncorrected misstatements are immaterial to the financial statements under audit.

The auditor should communicate to the audit committee those corrected misstatements, other than those that are clearly trivial, related to accounts and disclosures that might not have been detected except through the auditing procedures performed, and discuss with the audit committee the implications that such corrected misstatements might have on the company's financial reporting process.

The auditor should communicate to the audit committee other material written communications between the auditor and management.

The auditor should communicate to the audit committee the following matters related to the auditor's report:

- a. When the auditor expects to modify the opinion in the auditor's report, the reasons for the modification, and the wording of the report; and
- b. When the auditor expects to include explanatory language or an explanatory paragraph in the auditor's report, the reasons for the explanatory language or paragraph, and the wording of the explanatory language or paragraph.

Auditing Standard no. 16 further provides that the auditor should communicate to the audit committee any disagreements with management about matters, whether or not satisfactorily resolved, that individually or in the aggregate could be significant to the company's financial statements or the auditor's report. Disagreements with management do not include differences of opinion based on incomplete facts or preliminary information that are later resolved by the auditor obtaining additional relevant facts or information prior to the issuance of the auditor's report.

The auditor should communicate to the audit committee any significant difficulties encountered during the audit. Significant difficulties encountered during the audit include, but are not limited to:

- a. Significant delays by management, the unavailability of company personnel, or an unwillingness by management to provide information needed for the auditor to perform his or her audit procedures;
- b. An unreasonably brief time within which to complete the audit;
- c. Unexpected extensive effort required by the auditor to obtain sufficient appropriate audit evidence;
- d. Unreasonable management restrictions encountered by the auditor on the conduct of the audit; and
- e. Management's unwillingness to make or extend its assessment of the company's ability to continue as a going concern when requested by the auditor.

And finally, AS no. 16 provides that the auditor should communicate to the audit committee other matters arising from the audit that are significant to the oversight of the company's financial reporting process. This communication includes, among other matters, complaints or concerns regarding accounting or auditing matters that have come to the auditor's attention during the audit and the results of the auditor's procedures regarding such matters. In other words, is there anything else that the auditor knows that that audit committee should know about?

## B. Reviews

What is a review and what information does a review provide? I have written on this topic previously. My view differs from what the courts have held. The courts have essentially held that as a review is not an audit and provides no audit opinion by the external auditor, a review engagement places no responsibilities on the auditor. Then I must question whether there is any value to a review, and if not then why have one done? The pronouncements in fact do require the external auditor performing a review to perform specific tasks and actions in conformity with professional standards. And it is those tasks and actions, as they should be performed by the audit professional/accountant that provide value, if any, to having a review performed. At least in my mind, the fact that an audit opinion isn't provided isn't determinative of the issue. And as an audit committee member, if the external auditor/accountant is performing a review engagement, I want to be sure that the review provides me with the information that a review is required to provide.

The following is a link to my detailed pre-SSARS 21 paper, discussing information that a compilation or review can provide, <http://directorofficernews.com/2015/07/30/my-paper-information-that-compilations-and-reviews-can-provide/>

In October 2014, the SSARS 21 pronouncement was enacted for performing review and compilation engagements, effective for engagements performed for periods ending on or after December 15, 2015. I will be updating these materials after I do an extensive evaluation of SSARS 21; however, I don't expect SSARS 21 to reduce the information that a review or compilation can provide.

## C. Compilations

What is a compilation and what information does a compilation provide? See my comments above about the value of a review. A compilation engagement is significantly less in scope than a review. However, the engagement still must be performed in conformity with professional standards, and the external auditor performing a compilation could become aware of information that the auditor is required to communicate.

The following is a link to my detailed pre-SSARS 21 paper, discussing information that a compilation or review can provide, <http://directorofficernews.com/2015/07/30/my-paper-information-that-compilations-and-reviews-can-provide/>



In October 2014, the SSARS 21 pronouncement was enacted for performing review and compilation engagements, effective for engagements performed for periods ending on or after December 15, 2015. I will be updating these materials after I do an extensive evaluation of SSARS 21; however, I don't expect SSARS 21 to reduce the information that a review or compilation can provide.

[Hyperlink Back to Main Table of Contents](#)

## **VII. AUDIT COMMITTEE EVALUATION OF THE EXTERNAL AUDITOR**

I am working on this section. There isn't much to say at this time; however, this is an area of potential new significant new developments in the near future as there are proposed new rules and pronouncements that are outstanding for comment. I expect that new rules and pronouncements will be enacted and that these topics will significantly impact audit committee responsibilities and the relationship between the audit committee and the external auditor. The PCAOB has become considerably more active and aggressive enacting pronouncements, disseminating information, and performing its responsibilities and overseeing the public auditing firms. For now, see the links below discussing the new proposals on the topic of Audit Committee Evaluation of Audit and External Auditor Quality (SEC, PCAOB and NYSE, NACD, CAQ, etc. new materials on this topic):

June 29, 2015, blog post, <http://directorofficernews.com/2015/06/29/new-audit-committee-standard-of-care-external-auditor-assessment-tool-from-nacd-nyse-governance-services-center-for-audit-quality-and-others/>

July 3, 2015, two blog posts, <http://directorofficernews.com/2015/07/03/pcaob-issues-concept-release-on-audit-quality-indicators-important-for-audit-committees-and-external-auditors/> and <http://directorofficernews.com/2015/07/03/sec-issues-concept-release-about-audit-committee-disclosures-about-the-external-auditor/>

Audit Committee Dialogue May 7, 2015, PCAOB Release no. 2015-003  
<http://pcaobus.org/sites/digitalpublications/Pages/auditcommittees.aspx>

[Hyperlink Back to Main Table of Contents](#)

## **VIII. INTERNAL CONTROLS**

### **A. COSO 2013**

I am working on this section. Internal controls and COSO 2013 are important and developing topic areas. For now see the links and discussions below in this part VIII, and part VI above, Audits, Reviews and Compilations, discussions about SAS nos. 109, 114, 115 and 122, and PCAOB AS no. 5. Significant materials have been and are being prepared by internal control professionals – I will be adding new materials shortly. Audit Committee members of public companies, and in general of other organizations, must be familiar with COSO 2013.

COSO 2013, which is now in effect, contains the following broad internal control topic or criteria areas:

### COSO 2013 Internal Control Framework

#### Three Categories of Objectives:

- Operations
- Reporting
- Compliance

#### The Five Integrated Components of Internal Control and Their 17 Principles:

##### Control Environment

1. Demonstrates commitment to integrity and ethical values
2. Exercises oversight responsibilities
3. Establishes structure, authority and responsibility
4. Demonstrates commitment to competence
5. Enforces accountability

##### Risk Assessment

6. Specifies suitable objectives
7. Identifies and analyzes risk
8. Assesses fraud risk
9. Identifies and analyzes significant change

##### Control Activities

10. Selects and develops control activities
11. Selects and develops general controls over technology
12. Deploys through policies and procedures

##### Information & Communication

13. Uses relevant information
14. Communicates internally
15. Communicates externally

##### Monitoring Activities

16. Conducts ongoing and/or separate evaluations
17. Evaluates and communicates deficiencies

September 13, 2014, blog post, <http://directorofficernews.com/2014/09/13/gearing-up-with-coso-2013-internal-control-framework-and-principles/>

May 6, 2015, blog post (including a link to a post and discussion by Norman Marks, <http://directorofficernews.com/2015/05/06/lessons-learned-from-the-transition-to-coso-2013-2/>

COSO website (in general) <http://coso.org/>

COSO guidance website with link to COSO 2013, <http://coso.org/guidance.htm>

Protiviti, link to The Bulletin, Top 10 Lessons Learned From Implementing COSO 2013, <http://www.protiviti.com/en-US/Documents/Newsletters/Bulletin/The-Bulletin-Vol-5-Issue-10-Top-10-Lessons-COSO-2013-Protiviti.pdf>

The IIA, Governance and Internal Control (July 2015), <https://na.theiia.org/standards-guidance/Public%20Documents/2015-Leveraging-COSO-3LOD.pdf>

## B. Fraud – Example Means and Prevention

### **Financial Fraud Prevention & Detection**

David Tate, Esq.

<http://directorofficernews.com>

This discussion primarily pertains to financial statement fraud--that is, financial statements that contain intentionally, or, in some circumstances, recklessly, false statements or entries designed to deceptively enhance the company's financial picture. Internal accounting controls may not always be sufficient, but they are the first line of defense in preventing and detecting fraud.

#### Typical Means By Which Fraud Is Perpetrated

Financial statements are often fraudulently enhanced by one or a combination of the following means: (1) reduce liabilities, (2) increase assets, (3) increase revenues, (4) reduce expenses, or (5) reclassify assets or liabilities as being long-term or short-term. The discussion in this paper assumes the person perpetrating a fraud will be attempting to enhance the financial statements. However, in some circumstances, the objective of the perpetrator may be to degrade the financial statements--for example, when the amount of a payment or liability due is based on the financial status of the enterprise and will be favorably reduced when that status is diminished. Many of the discussion in this paper are also useful for detecting fraud when the objective is to degrade the financial statements. In that circumstance, you need merely to reverse the emphasis of the method of detection. For example, one means of enhancing financial statements is to reduce cost of goods sold by increasing ending inventory. The reverse would be a means of degrading the financial statements--that is, an increase in the cost of goods sold would degrade the financial statements. Such an increase could be accomplished by reducing ending inventory, possibly by consignments.

There are also means of enhancing financial statements that arguably may not constitute fraud. Examples may include smoothing (i.e., managing the financial numbers to obtain a steady

rate of growth); grouping accounts, transactions, or financial amounts in a manner that tends to obscure or hide the individual components of the group; or recording transactions or amounts in improper accounts for concealment purposes. Fraud is a legal term generally requiring (1) a misrepresentation, concealment, or nondisclosure by the person perpetrating the fraud; (2) the defrauding person's knowledge of or reckless disregard for the fraudulent conduct (e.g., knowledge of the falsity or reckless disregard for the truth of the matter); (3) the defrauding person's intent to induce reliance upon the conduct; (4) justifiable reliance on the fraud by the defrauded person or the market in general; and (5) damages suffered by the defrauded person. Thus, it is possible that in certain circumstances (e.g., when knowledge or reckless disregard of the fraudulent conduct is evident) conduct such as smoothing could be considered fraudulent.

Every financial statement account is susceptible to fraudulent enhancement. However, in practice, a perpetrator probably would attempt to enhance financial statements by the following means: (1) by affecting income statement revenue or expense accounts to increase net income; (2) by increasing assets or reducing liabilities to enhance the overall balance sheet picture; or (3) by reclassifying long- or short-term assets or liabilities to enhance the current asset or net current asset portion of the balance sheet.

The following is a representative, but not exhaustive, list of the balance sheet and income statement accounts and related possible means of fraudulent enhancement.

#### 1. Cash

- a. Delaying until the next accounting period the recording of disbursements made near but before the balance sheet date.
- b. Recording amounts received or expected to be received in the next accounting period as being received in the current period.
- c. Fabricating fictitious cash items, such as bank accounts, transactions, or entries.
- d. Not disclosing that certain cash accounts are in some manner restricted.
- e. Classifying long-term cash accounts as current assets.

#### 2. Accounts Receivable

- a. Fabricating fictitious sales invoices.
- b. Reporting goods on consignment as sales.
- c. Over billing for merchandise sold.
- d. Invoicing/shipping merchandise that was not purchased.

- e. Failing to recognize or disclose the value of return rights or contingent liabilities on sales that contain those rights.
- f. Underestimating the allowance for bad accounts or returns.
- g. Unreasonably lowering required credit qualifications to increase sales. This action would also affect the allowance for bad accounts or returns.
- h. Factoring receivables with recourse, but not recognizing an appropriate contingent liability for the recourse.
- i. Over reporting receivables arising from sales to affiliates. For consolidated financial statements, intercompany receivables should be eliminated. Even if the elimination of affiliate or intercompany receivables is not required, those receivables may not have arisen from actual sales or arm's-length transactions; that is, valuations of those transactions may be suspect.
- j. Extending or modifying receivable due dates or terms without making necessary disclosures or recognizing an appropriate valuation loss.
- k. Reclassifying long-term receivables as current receivables.
- l. Recognizing revenue when the revenue-generating process is not yet complete (e.g., the collection of the sales price is not reasonably assured).
- m. Recognizing revenue from "sales" of merchandise to customers but holding or warehousing the merchandise for later use by the customer and delaying billing--essentially, preselling merchandise.
- n. Carrying as receivables amounts due from related parties (e.g., subsidiaries) when there is no expectation of payment or delay in payment is expected.
- o. Recognizing revenue from installment sales prior to the appropriate period.

### 3. Inventory

- a. Overvaluing existing inventory.

- b. Counting nonexistent inventory or sold merchandise that is being warehoused for customers.
- c. Not reducing the value of obsolete, damaged, or slow-moving inventory.
- d. Improperly changing or disclosing a change in inventory accounting methods.
- e. Failing to disclose pledged inventory when required.
- f. Reclassifying old and new inventory to alter valuation under the inventory accounting conventions (e.g., under the LIFO and FIFO inventory methods).
- g. Counting inventory sold and warehoused under a repurchase agreement.

#### 4. Property, Plant and Equipment

- a. Recording expenses as acquisitions of property, plant, and equipment to delay recognizing the entire immediate expense.
- b. Reducing or delaying depreciation.
- c. Recording inflated property, plant, and equipment values (e.g., recording those assets at fictitious values or at appraised value instead of cost value).
- d. In a purchase of multiple assets, allocating the purchase price to property, plant, and equipment as opposed to short-term assets such as inventory so as to write-off expenses over a longer period of time.
- e. In a purchase of multiple assets, reducing values allocated to tangible assets so as to increase goodwill, which can be amortized over a longer period of time.

#### 5. Investments/Securities

- a. Overvaluing investments or securities--assigning an excessive value when no readily available market determines the value or, in the case of transactions with related parties (e.g., in an asset for stock transaction), overvaluing the asset to allow overvaluation of the stock.

- b. Reclassifying long-term investment/security assets as current assets to increase liquidity.
- c. Pledging investments as security without appropriate financial statement disclosure.
- d. Classifying current marketable securities as noncurrent assets to allow an unrealized loss of value to be recorded as a reduction of equity instead of as a reduction of net income. Similarly, for noncurrent marketable securities, improperly classifying an unrealized loss in value as temporary instead of as other than temporary to allow the loss to be recorded as a reduction in equity instead of as a reduction in net income.

#### 6. Taxes

- a. Recording an excessive or insupportable income tax receivable as a liability under Statement of Financial Accounting Standards 109.

#### 7. Leases

- a. Improperly treating a lease as an operating lease (e.g., instead of as a sales lease) in an attempt to avoid recording or disclosing lease payment liabilities.

#### 8. Goodwill

- a. Reducing current expenses by allocating purchase costs to goodwill, which is amortized over a longer period of time.
- b. Paying too much for goodwill to increase assets.
- c. Although not necessarily fraudulent, as with all assets carried at historic cost, the current fair value of goodwill may be less than indicated on the balance sheet because the goodwill may have lost value (e.g., due to changes in the market, product, or the enterprise subsequent to the initial valuation and recording of the goodwill).

#### 9. Intangibles

- a. Overvaluing an intangible (e.g., the allowable value of a patent) to increase total assets.
- b. Similar to goodwill, although not necessarily fraudulent, the current fair value of an intangible may be less than indicated on the balance sheet because the intangible may have lost value (e.g., the

market, product, or the enterprise may have changed or become obsolete).

- c. Similar to goodwill, reducing current expenses by allocating costs to an intangible asset, which is amortized over a longer period.

## 10. Liabilities

- a. Not recognizing or disclosing contingent liabilities.
- b. Improperly treating a sales lease as an operating lease.
- c. Not recognizing or disclosing the value of a right of return with respect to a sale.
- d. Improperly recognizing a sale when the earnings process is not yet complete.
- e. Restructuring or modifying loans or receivables when they become uncollectible without recognizing or disclosing, when required, a related loss in value, contingent liability, or change in terms.
- f. Factoring an asset such as a receivable with recourse but failing to record or disclose the contingent recourse liability.
- g. Recording a loan as receipt of cash and an increase in equity instead of as a liability increase. The enterprise makes the monthly payment by crediting cash and debiting owner's equity, thereby making the monthly payment look like owner drawing and allowing the enterprise not to record the liability.
- h. Improperly classifying a current liability as long-term to improve net current asset value.
- i. Improperly excluding or not describing an off-balance sheet transaction or entity item.

## 11. Equity

- a. Recording a loan from the owners as equity and payments on the loan as owner withdrawals. The list of possible abuses of the equity account is almost endless. Thus, all significant changes in the equity account should be reconciled to determine that they are in fact not more appropriately classified as entries affecting other balance sheet or income statement accounts.



## 12. Revenues/Gains

- a. Recognizing revenues from sales for which the earning process is not yet complete (e.g., collection of the sales price is not reasonably assured).
- b. Recognizing unearned revenues before appropriate.
- c. Recognizing revenues in the current period for sales that will occur in the following period.
- d. Failing to recognize the value of a right of return or repurchase obligation with respect to sales that contain those terms.
- e. Classifying nonoperating or extraordinary revenues or gains as operating.
- f. Inflating revenues from sales to related parties, affiliates, or subsidiaries (e.g., by reporting fictitious sales, overvaluing sales amounts, or not eliminating intercompany transactions in consolidated financial statements).
- g. Deferring until the following period credit memoranda, sales returns, or allowances that are attributable to the current period.
- h. Recording consignments as sales.
- i. Increasing sales through unusual circumstances by the use of adjusting or general journal entries.
- j. Fabricating fictitious sales invoices.
- k. Over billing for merchandise sold.
- l. Invoicing/shipping merchandise not purchased.
- m. Underestimating the allowance for bad accounts or returns.
- n. Increasing sales by unreasonably lowering required credit qualifications and not evaluating the adequacy of the allowance for returns.
- o. Recognizing installment sales revenue prior to the appropriate period.
- p. Recognizing revenue from "sales" to customers, but holding or warehousing the merchandise for later use with a corresponding delayed billing.

- q. Recognizing currency translation gains from foreign operations as income instead of as a separate component of equity.
- r. Failing to properly disclose or account for a change in accounting method, change to an improper accounting method, or improperly changing to an accounting method that is otherwise acceptable but that is not a preferred method when compared to the method currently in use.

### 13. Cost of Goods Sold

- a. Overvaluing ending inventory to reduce cost of goods sold, resulting in higher net income.
- b. Counting nonexistent inventory.
- c. Not reducing the value of obsolete, damaged, or slow-moving inventory.
- d. Counting inventory sold but warehoused for customers.
- e. Reclassifying old and new inventory to alter valuation under the inventory accounting conventions (e.g., under the LIFO and FIFO inventory methods).
- f. Counting inventory sold and warehoused under a repurchase agreement.
- g. Counting inventory consigned to the enterprise, or inventory received from an affiliate but not owned by the enterprise.

### 14. Expenses

- a. Recording an expense as a prepaid expense, an asset with a usefulness extending beyond the end of the current fiscal year, thereby reducing or delaying current period charge-off to future periods.
- b. Delaying until the next accounting period the recording of disbursements made near but before the balance sheet date.
- c. Recording current expenses as acquisitions of property, plant, and equipment, thereby deferring or eliminating the expense.
- d. Reducing or delaying depreciation.

- e. In a purchase of multiple assets, allocating the purchase price to property, plant, and equipment as opposed to short-term assets such as inventory so as to write-off expenses over a longer period of time.
- f. In a purchase of multiple assets, reducing values allocated to tangible assets so as to increase goodwill, which can be amortized over a longer period of time.
- g. Not recognizing or disclosing liability contingencies.
- h. Not recognizing or disclosing the value of a right of return with respect to a sale.
- i. Recording a loan as a receipt of cash and an increase in equity instead of as a liability increase. The enterprise makes the monthly payment by crediting cash and debiting owner's equity, thereby making the monthly payment look like owner drawing and allowing the company not to record the liability.

## 15. Pension Plans

- a. Pension plans are accounted for as independent entities separate from the general enterprise accounting records and financial statements. It is not within the scope of this paper to discuss accounting principles for pension plans. However, although not necessarily related to fraudulent practices, analysis of the financial statement of a company may also include analysis of the financial statement disclosure notes pertaining to the company's pension plan liabilities, including various past and current costs or liabilities, unrealized gains and losses, types of investments, and asset fair valuation. Department of Labor random reviews of employee benefit plan audits reveal that a percentage of plans do not comply with Generally Accepted Auditing Standards and Employee Retirement Income Security Act requirements.

### Detecting Fraud

Internal accounting controls are the primary means of detecting and preventing fraud. Of course, it becomes more difficult to detect or prevent fraud when two or more employees become joint perpetrators or when a lower-level employee, such as a mid-level manager, allows improprieties by senior-level person out of a fear of reprisal. Fraudulent conduct is not limited to senior personnel--it is not unusual for mid- or lower-level personnel to perpetrate fraud to achieve company growth objectives, advancement, or recognition, or to conceal failures or mistakes.

The following is a listing of some of the means of detecting fraud, including potential warning signals.

1. Analyze the integrity of management. Is management honest, cooperative, not overly egotistic, and willing to work with others? Does management set reasonable objectives? Is there a propensity to obtain desired results at all costs? Is undue pressure placed on personnel to achieve management's goals? Does the company have a mechanism for allowing employees to report improprieties or to make suggestions of improvement, in confidence if necessary? Is compensation unreasonably tied to the performance results of the company?

2. Does the company have a reliable accounting department and internal control system, and an appropriately trained and staffed internal audit department that has sufficient authority to perform its function? Does the internal audit function work with senior management, and also independently report to the directors? The audit committee may consider reviewing internal audit employment hiring and terminations. Does the audit committee diligently oversee the internal audit function, and internal controls? Does the company have a compliance and ethic function and/or a governance, risk and compliance function, who oversees the function and integrates the function with corporate activities, and does the audit committee sufficiently interact with the function?

3. Does the audit committee seek to obtain independent auditors (including the lower-level staff accountants of the independent auditors) who are knowledgeable about the company and who understand the company's desire not just to obtain a "clean" audit opinion but also to constantly improve the internal control system, keeping in mind cost-benefit considerations? The audit committee may consider obtaining comments from the lower-level auditors about the conduct of the company's employees during the course of the audit.

4. Analyze the practices and trends in the industry as compared to the practices and trends of the company. Is the company highly visible? Is there an impression that the company is a high flier such that less than extraordinary results would be considered disappointing? Is the company experiencing unusual profits, growth, or losses? Are the company and its primary areas of business on solid financial and business grounds?

5. Material fraud often is exposed by analytic analysis of changes in financial information, account balances, and significant financial ratios between different accounting periods. Significant changes should be investigated in detail. Analytic analysis should be performed on a company comparison basis; that is, by comparing current company financial information with similar prior financial information of that same company, and by comparing the company to industry averages and trends and other similarly situated companies. Although cost benefit should be kept in mind, such an analysis can also be done at the department level on small accounts. The following are some of the key ratios that may be considered for fraud analysis. Most of the ratios are also useful for general financial analysis and budgeting.

- a. Sales or revenues compared to cost of goods sold.
- b. Sales or revenues compared to assets or investments.

- c. Gross sales or revenues compared to returns and credits.
- d. Sales or revenues compared to average inventory.
- e. Sales or revenues compared to average receivables.
- f. Average receivables compared to sales per day.
- g. Current assets compared to current liabilities.
- h. Reserve for uncollectible receivables compared to receivables.
- i. Cash plus cash equivalent current assets compared to current liabilities.
- j. Total debt compared to total assets.
- k. Profit or income compared to net worth, assets, sales, or revenues.
- l. Earnings compared to interest expense.

6. Statement of cash flows ratio analysis should be considered, but often might not be utilized. The statement of cash flows presents changes in actual cash accounts during a period of time, as opposed to the income statement, which accrues income and expenses although actual cash may not have been received or disbursed. Thus, the statement of cash flows is useful to management as an indicator of a company's ability to generate actual cash to pay debts and dividends or meet operating cash needs. With respect to financial statement fraud, the statement of cash flows may be useful as an indicator of the company's going concern status--that is, an indicator of the likelihood of bankruptcy--and to detect unusual changes in sales or inventory. The following may be useful ratios for statement of cash flows analysis:

- a. Cash from operations compared to sales.
- b. Cash from operations compared to accounts receivable.
- c. Cash from operations compared to income from operations.
- d. Cash from operations compared to inventory.
- e. Total debt compared to cash from operations.
- f. Cash from operations compared to debt payments (long- and short- term), operations asset purchases plus dividends paid, and individually, debt payments, asset purchases, and dividends paid compared to cash from operations.

7. Compare the financial statements or other pertinent information to another source that is comparable and more likely to be reliable. For example, tax return information, if available, may be a more reliable indication of sales and expenses than the financial statements because the company would be less inclined to overstate income and understate expenses on its tax return.

8. Determine whether accounts receivable turnover is slowing down or whether accounts receivables are growing faster than sales.

9. Determine whether inventory turnover is slowing down or whether inventories are growing faster than sales.

10. Investigate whether employee turnover is unusually high in any particular department or within a broad authority level, such as mid- or upper-management.

11. Investigate whether the company has a history of changing audit firms, has recently changed audit firms, or has had disputes with its auditors.

12. Investigate transactions with related parties, subsidiaries, or affiliates.

13. Determine whether the company engages in transactions that require appraisals or valuations for reporting purposes.

14. Investigate whether insider purchases or sales of the corporation's securities are unusually high or low.

15. Determine whether the company has adequate working capital.

16. Determine whether the quality of receivables is deteriorating based on an aging of receivables.

17. Determine whether inventories are increasing in comparison to normal cost of goods sold ratios.

18. Have sales incentive programs become unreasonably liberal?

19. Have sales returns or credits increased, especially after the end of the accounting period?

20. Investigate the company's off-balance-sheet financing.

21. Determine whether the company is engaged in an industry area that is, or has assets that are highly susceptible to contingent liabilities.

## Conclusion

Properly enacted and functioning internal accounting controls, along with an understanding of some of the means of perpetrating and analytically detecting financial statement fraud will in most circumstances deter and prevent the occurrence of fraudulent financial statements. Significant financial statement fraud seldom goes undetected for an extended period of time.

C. Select Accounting Transaction Internal Control Safeguards

Many accounting resources provide extensive lists or charts of possible internal control safeguards. Those resources are helpful and may be consulted for suggestions and to save time when developing or reviewing a business's internal control system. However, it is equally and perhaps more beneficial to understand the basic concept of internal control: to have different employees perform different key duties or activities in the transactional process to prevent mistakes and intentional breaches. See also the discussion above at the beginning of this part about COSO 2013.

The transactional process generally can be divided into five broad functional areas, each of which should, if possible, be staffed by employees who are independent of the other functional areas:

1. The transaction; for example, the sale of merchandise by a clerk.
2. Authorization: for example, credit department or other approval when required by the business's policies.
3. Accounting recordation.
4. Asset custody; for example, cash, checks, or inventory custody.
5. Verification/reconciliation; for example, intradepartmental account reconciliation and/or verification by independent personnel such as internal auditors.

Some businesses and organizations may not have sufficient personnel to permit different employees to perform each of the five functional areas. In that circumstance, the business should attempt to achieve maximum employee independence within the functional areas and depend more heavily on the fifth function, verification/reconciliation.

Most of the specific personnel duties within the transactional process generally can be classified into the following activity areas:

General ledger	Accounts receivable
Cash receipts	Accounts payable
Cash disbursements	Mail
Sales	Banking deposits
Purchasing	Banking reconciliation
Credit	Payroll delivery
Billing	Petty cash
Payroll	Personnel
Inventory	Cash/financial asset custodian
Shipping	Receiving
Hard asset custodian	Intellectual property custodian

Internal control/internal auditors    Management authority

Insurance and similar safeguards

Rather than completely relying on lists or charts of possible internal control safeguards, for any given transaction it is possible to trace the transactional process and staff personnel so that broad functional areas and key personnel duties or activities are performed by independent/different personnel.

A typical sales transaction may involve the following personnel activities:

Credit	Mail
Sales	Collections/cash receipts
Accounts receivable	Bank deposit
Inventory/shipping	Bank reconciliation Billing
Billing	

A typical purchase transaction may involve the following personnel activities:

Purchasing	Inventory
Accounts payable	Cash disbursements
Receiving	Bank reconciliation

A typical payroll transaction may involve the following personnel activities:

Personnel	Payroll delivery
Payroll	Bank reconciliation
Cash disbursements/check preparation	

For the sales, purchase, and payroll transactional processes just described, each personnel activity should, if possible, be performed by a different employee. Cash custody personnel should be independent of general ledger, accounts receivable, accounts payable, cash disbursements, cash receipts, and banking personnel. General ledger personnel should at least be independent of cash custody, cash receipts, and cash disbursements personnel and as many other employees performing activities in the transactional process as possible. Employees responsible for making bank deposits should be independent of cash custody, cash receipts, cash disbursements, and bank reconciliation personnel.

Similar to the previous discussion relating to the five broad functional transaction areas, in some businesses—for example, small- and medium-sized businesses—it is more likely there will be insufficient personnel to allow all of the above-described activities to be performed by independent personnel. The business should attempt to achieve maximum separation of activities with the employees available and may consider hiring additional personnel if it is deemed necessary. As maximum separation of activities becomes less possible, more emphasis must be placed on documentation, limiting unnecessary personnel access to facilities/assets, transactional and asset custody authorization, intradepartmental reconciliations, and independent verifications by internal auditors or other sources.

Additional selected internal control safeguards may be considered for adoption. However, each business must analyze its particular internal control needs and requirements. Although the following



list does not include all possible safeguards, and in fact the number of possible safeguards is endless, the list includes many of the important safeguards and, more importantly, in conjunction with the previous discussion, provides a reference that you can apply to many internal control situations. The list also should be considered in conjunction with the fraud discussion in this part.

## 1. General safeguards

- The business maintains an organizational chart of personnel and a chart of accounts.
- The business has adopted and documented its business ethics policies and the responsibility and authority of each significant participant or group of participants in the accounting and internal control system.
- Procedures have been adopted and documented safeguarding access to and storage of the accounting records, including computerized records.
- The business has adopted procedures for testing and investigating the integrity and reliability of its accounting and internal control systems (including the use of individuals outside the business when necessary for independence or confidentiality purposes with respect to discovery by outside third-party persons, entities, or agencies, or people inside the business).
- The business requires preventative pretransactional due diligence in all appropriate situations to help avoid later disputes or unexpectancies.
- Transactions between the business and related parties (e.g., management, owners, the immediate families of management and owners, and other persons or entities that can significantly influence the management or policies of the business) receive appropriate authorization and are conducted at arm's length similar to transactions between the business and unrelated parties.
- Employees who handle cash, checks, securities, and other valuables are bonded.
- Employee functions and duties are regularly rotated; vacations are enforced.
- Budgets are used, and at least significant deviations from those budgets are investigated.
- Special accounting journal entries require approval or at least are routinely reviewed by independent personnel.
- To the extent possible, management has knowledge of the employees who participate in the various accounting functions and their relationships to other employees in those functions.
- When a corporation owns or controls 20 percent or more of another corporation, including a foreign corporation, and also in some circumstances when the corporation owns or controls less than 20 percent of another corporation, the owning or controlling corporation investigates the internal control of the owned or controlled corporation to ensure that the internal control satisfies the provisions of the Foreign Corrupt Practices Act.
- The business employs an in-house person who is designate responsible for public disclosures, except in special or limited circumstances. Further, each time the business makes a statement of opinion interpreting or estimating its existing or expected future financial situation, that statement first must be evaluated and approved by designated, competent, and knowledgeable personnel or professional advisors.
- Accounting estimates, contingencies, allowances, expense deferrals and revenue accruals in unusual situations (e.g., revenue accruals when there is a right of return or it is not clear the earnings process is complete) are evaluated and approved by designated, competent, and knowledgeable personnel.
- Cybersecurity is in place, appropriate and updated.

## 2. Cash receipts and disbursements safeguards

- Personnel who open the mail place restrictive endorsements on checks and make a list of cash, checks, and any other payments received.
- The list referred to immediately above is verified against daily deposit slips and the cash receipts journal.
- Prenumbered receipts or other transactional documentation records are prepared for cash sales, and cash sales are reconciled daily with cash collections and receipts records.
- Personnel independent of the sales, accounts receivable, and cash functions review customer discounts and allowances.
- Expense and other payments (other than payments from petty cash) are made by prenumbered check.
- Checks are signed by an appropriately authorized person who is independent of the employee(s) who prepares the checks.
- Payments are made only if a check or a request for payment from petty cash is accompanied by supporting documentation and the documentation then is marked as paid.
- Petty cash and check disbursements above specified amounts require approval.
- Payments from petty cash, as all other payments, are, in some manner, recorded on prenumbered slips.
- Petty cash fund balances are small, requiring frequent reimbursement.
- Access to and authority over company credit card use is strictly controlled. Credit card bills are routinely reconciled with supporting vouchers and bills.

### 3. Receivables: Notes and accounts safeguards

- Notes require proper authorization.
- The notes custodian is independent of the cashier and other accounts receivable personnel.
- An aging of accounts is maintained and reviewed by an employee who is independent of credit and accounts receivable personnel.
- Write-offs and prenumbered credit memoranda require approval by a designated employee who is independent of the credit manager and accounts receivable personnel.
- Employee advances require authorization.

### 4. Inventory safeguards

- Inventory access is limited to authorized personnel and, when necessary, is controlled by a documented log.
- Inventory receiving, issuance, and shipping reports are maintained.
- Inventory records are maintained by personnel who do not have access to the inventory.
- Physical inventories with the use of prenumbered tags are taken by personnel who are independent of inventory personnel.

### 5. Securities/investments safeguards

- Securities are stored in a vault that requires at least two authorized persons for access.
- A log is maintained of all persons visiting the vault.
- A log of securities placed in and taken out of the vault is maintained by personnel who are independent of personnel who have access to the vault.
- Prenumbered vault deposit and withdrawal vouchers are required.
- Physical securities inventories are taken periodically by personnel who do not have access to the vault or vault records.
- The securities custodian is independent of the securities records, general ledger, and cash receipts and disbursements functions.

### 6. Property, plant, equipment and intellectual property safeguards

- Purchases, retirements, and dispositions of property or equipment require authorization, and a work order or voucher system is maintained for such.
- A record is kept of assets assigned for use by employees, and that record is periodically verified by physical confirmation.
- Property and equipment inventories are taken periodically by employees who do not have access to inventory records.
- Intellectual property is recorded, valued and properly calendared for future actions.

#### 7. Payables: Notes and accounts safeguards

- Significant borrowing is approved by management and requires at least two signatures.
- An employee who does not have authority to sign checks or notes keeps the payables register.
- Paid notes, interest coupons, bonds, and other documents indicating a liability are marked as canceled or paid.
- Account payable adjustments or corrections require approval.

#### 8. Capital securities safeguards

- A registrar and a transfer agent, both of whom are independent of the business, are employed to control capital stock custody, transfers, and dividend payments, or those duties are assigned to a designated officer.
- Surrendered or retired certificates are canceled.
- Corporate stamps and seals are controlled by a designated officer.

#### 9. Sales, shipping, and receiving safeguards

- Sales orders, sales invoices, and shipping memoranda are prenumbered.
- All sales orders, or those above a specified amount, are approved by designated personnel.
- The receiving department prepares prenumbered receiving reports.
- Prenumbered credit memoranda are prepared for returns and require appropriate approval.
- Sales to employees are handled in the same manner as sales to customers (e.g., they receive no special treatment, unless appropriately authorized).

#### 10. Purchases safeguards

- Purchase orders and invoices are prenumbered.
- Purchase orders and invoices, or those above a specified amount, require approval.

#### 11. Payroll safeguards

- Payroll is periodically verified with personnel records by employees who are independent of payroll.
- Payroll is signed by the payroll employee preparing it and authorized or approved by a designated officer, or it is prepared by the payroll department and signed by a designated officer.
- Employees are paid by check.

[Hyperlink Back to Main Table of Contents](#)

## **IX. INTERNAL AUDIT**

I am working on this part. Internal audit is or should be extremely important to the audit committee. But internal audit as a profession and as a resource to the audit committee is evolving. In fact, the Institute of Internal Auditors has just recently updated some of the discussions about what internal audit is and should or could be doing. Every internal audit department works differently and interacts differently with executive management, the board and the audit committee. Although there are significant materials available on this topic, there is little to no mandatory guidance other than that some entities must have an internal audit function whereas for others it is discretionary. As the audit committee significantly relies on other people to provide the committee with information so that the audit committee member can satisfy his or her oversight requirements, a properly functioning internal audit department can be significantly helpful to the audit committee and its oversight function. In the months that follow I will be adding significantly to this part, both with my own materials and with links to materials by other people. You can also find regular posts about internal audit on my blog at <http://directorofficernews.com>.

The following is the definition of internal audit from the Institute of Internal Auditors (IIA), which is a pretty broad definition:

***“Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.”***

As I have indicated, internal audit is in and going through a time of change. The following is a link to the IIA page discussing The Framework for Internal Audit Effectiveness: The New IPPF, <https://na.theiia.org/standards-guidance/Pages/New-IPPF.aspx>

The following is a link to the main IIA website, <https://na.theiia.org/Pages/IIAHome.aspx>

From my perspective, as an audit committee member, it is important to have an internal audit function that is properly staffed and funded, that has agreed upon tasks to timely perform, that communicates and reports to both executive management and the audit committee/board.

Note: add Tate article for The Association of Healthcare Internal Auditors: *How Internal Audit can Help the Audit Committee: an Audit Committee Member's Perspective*.

[Hyperlink Back to Main Table of Contents](#)

## **X. RISK MANAGEMENT**

Risk management is a broad subject matter area—there is also no single agreed upon definition or process for risk management. By statute or rule (and/or accepted prudence or standard in the industry) many organizations are now legally or quasi-legally required to exercise formal risk management, with board oversight. It is also not uncommon for the board to delegate risk oversight to a board committee, such as the audit committee; however, the board should remain engaged in risk management oversight even if preliminary responsibility is delegated to a

board committee. See also the discussions above in this paper about audit committee statutory responsibilities. My take on risk management: whether legally required or now, all entities (public, private, nonprofit and governmental) should be involved in risk management with board oversight. The below discussion is essentially an overview. I will be adding to these materials as important new developments, pronouncements and processes are expected shortly.

What is risk management and what does it include? There is no standard answer, and I am not proposing one in this paper as that is not the objective of this discussion. The objective in this paper is for the organization to consider and improve upon its risk management processes. Risk management is a process—or, more correctly stated, risk management is the processes—that are designed and implemented to help the organization achieve its mission, objectives and strategies—to get to where it wants to go. There can be a tendency to view risk management only from a liability avoidance perspective. While it is true that an aspect of risk management does involve avoiding and handling liability or potential liability situations, risk management is more broad in scope. Every organization has risk. Risk is a part of operations and business. Simplistically, there is risk that an event or an objective might not occur or might not occur as desired, when desired or to the extent desired—there is risk that an objective might be exceeded or that an unexpected desirable event occurs or opportunity arises—there is risk that a negative event may occur or that an event or objective will not be achieved. Of course, even with the “best” of risk management processes unexpectancies will occur—the occurrence of a unexpectancy, even a negative unexpectancy, does not mean that someone is at fault or that someone acted improperly.

Some risks and risk management processes are generally shared or similar across organizations and industries, whereas, of course, within organizations and industries risks and risk management processes obviously will vary.

Start by listing the organization's mission, objectives, strategies, and projects, and identifying and preparing a list of the risk factors that impact or could impact the organization in relation to achieving its mission, objectives, strategies and projects. The list is endless. First concentrate on what I would consider the most significant ones based on likelihood of occurrence (based on current conditions), likelihood of occurrence within a particular time frame, and potential for impact upon occurrence. An event or unexpectancy with a high likelihood of occurrence, even within the immediate future, but with little likely impact, probably is not as important to deal with right away as an event that has much less likelihood of occurrence (based on current conditions) but that carries the potential for high impact. This gets into the areas of risk assessment, appetite and tolerance. I do not like the terms risk appetite and risk tolerance – although apparently they are terms that are accepted for the purpose of risk management, they can be used to imply after the fact that the organization or board thought that the risk of an incident occurring was okay or acceptable.

The following is one recent risk management occurrence example. By historical standards the likelihood of a gulf oil spill might be slight, but the likely impact could be catastrophic. Of course, historical standards of likelihood could be an erroneous criteria as based on then existing current conditions (i.e., the then existing conditions of the equipment being used, training, and safety procedures—possible leading indicators of the risk event), the

likelihood of occurrence might have been higher. Leaks can happen although we all wish not; however, there would be no appetite or tolerance for the occurrence of a significant spill—presumably processes for addressing and preventing the risk of possible spill occurrence, and processes for emergency containment and remedial actions in the event of such a spill would be given the highest priorities.

The immediately following materials are from my 1-page risk and uncertainty management process and oversight paper.

1-Page Risk and Uncertainty Management Processes and Oversight  
 Dave Tate, Esq., <http://directorofficernews.com>, October 30, 2014

The following steps and processes are intended to help you with your risk and uncertainty management framework and approach. Currently for many activities there is no agreed upon or universally accepted or required overall approach. However, for certain and a growing number of businesses, activities and tasks by statute, regulation, rule or community standard or recommended approach there are requirements or approaches that have been required. You will need to know these for your situation. Otherwise you might find for your situation that some of the below steps are not needed, or that additional steps are needed. This is a rapidly changing area of law, responsibility and expectations, and your good judgment definitely is important in this process.

1. Identify the focus of the risk and uncertainty management – i.e., the organization, a division, location, project, or product, an activity, a category or risk type, etc.	11. Identify and evaluate the possible steps or processes available to prevent, control and manage the possible occurrence of the #5 potential risks or uncertainties.
2. Identify the people who will be involved in the risk and uncertainty management process, or if necessary reevaluate the people who were previously selected to be involved in the process.	12. Identify and describe the steps and processes adopted and their applications to address the specific #5 potential risks or uncertainties taking into consideration the additional information that you obtained in ##6-11.
3. Identify the goals, strategies, objectives, initiatives or missions, etc. for #1.	13. Identify the people, etc., who are responsible for the implementation of the steps and processes adopted.
4. Know the relevant risk and uncertainty management laws, statutes, regulation, rules and guidelines that apply to your industry, organization, people, activities/actions and #1.	14. Determine the timing for the implementation, and implement.
5. Identify the potential risks and uncertainties for ## 1 and 3.	15. Develop and establish processes to detect and determine whether a risk or uncertainty has already occurred or is occurring, and conduct an evaluation to identify existing or occurring risks and uncertainties.

<p>6. Identify the events, actions and root causes, etc. that could cause the #5 potential risks and uncertainties to occur, including multiple or interrelated events, actions and root causes, etc.</p>	<p>16. Identify, develop and establish steps and processes to respond to, control, mitigate and recover from risk and uncertainty occurrences.</p>
<p>7. Identify key indicators, leading indicators, and post indicators, if any, for ##5 and 6 occurring or having already occurred.</p>	<p>17. Develop and establish reporting and evaluation processes relating to implementation status, timing, successes, issues, and problems as prudent based on the facts and circumstances, make decisions, and take appropriate additional actions.</p>
<p>8. Evaluate the likelihood of the #5 potential risks and uncertainties occurring. Likelihood could, for example, be evaluated as low, medium, or high – unlikely, reasonably possible, or probable or likely – or by percentages – or evaluated by pre-leading indicators or events, or post-leading indicators or events – or by other means, criteria or measures.</p>	<p>18. Schedule and implement monitoring, potential monitoring trigger points and timing, and the people and departments responsible.</p>
<p>9. Evaluate the speed or velocity that the risks or uncertainties might occur or begin to occur or accelerate after initial occurrence.</p>	<p>19. Exercise overall oversight, review, evaluation, and possible reconsideration and modification of the above, make decisions, and take appropriate additional actions.</p>
<p>10. Identify, describe and evaluate the potential impact and harms, etc., and potential ranges of impact or harms if the #5 potential risks or uncertainties occur. Impacts or harms might be safety/physical, financial/economic, reputation, product or service related, or otherwise.</p>	

COSO website <http://coso.org/>

COSO guidance website with link to COSO 2013, <http://coso.org/guidance.htm>

COSO enterprise risk management guidance website link, <http://coso.org/-ERM.htm>

**[Hyperlink Back to Main Table of Contents](#)**

**XI. AUDIT COMMITTEE AGENDA, APPROACH AND DOCUMENTATION**

The audit committee agenda is extremely important as is the agenda for any board, committee, entity, organization or person. If you are assigned or want to accomplish a task, how are you going to go about getting it done? You can find new and different or updated suggestions

for audit committee agendas all the time. It has gotten to the point where sometimes it seems like everyone has something for which they believe the audit committee should be responsible.

Viewing this topic from 10,000 feet, the audit committee and its members (1) have functions and responsibilities that they are required by law to satisfy, and (2) they might have functions and responsibilities that they are required to accomplish and oversee because they have agreed to do so although not initially legally required, and (3) they might simply decide in their discretion to take on other functions or tasks although generally I don't recommend that they do so as the audit committee is a subcommittee of the board, should operate under the umbrella and review of the board, and probably doesn't need additional tasks and responsibilities. The category (1) functions and responsibilities are spelled out at least in broad terms in the various statutes, regulations and rules, and in the audit committee's charter. The category (2) functions and responsibilities should also be spelled out in the audit committee's charter, or by some other written means so that at least the board and the audit committee are in agreement as to the audit committee's responsibilities.

Sometimes it seems like a lot is being said, regularly or almost all the time, by a lot of different people and organizations about what the audit committee and its members should be focused on, or are or should be required to do. It's easy for people and organizations to add to the audit committee's agenda. You might know from my materials that I believe the audit committee agenda is pretty full, and that each audit committee and its members need to have a mutual understanding with the board and other necessary stakeholders about what the audit committee is required and delegated to oversee, and perhaps on some tasks how they are recommended or expected to go about accomplishing the oversight responsibilities even if those expectations are simply pursuant to the business judgment rule. A lot has been and is being asked and required of audit committees and their members – that's all well and good perhaps – accordingly, as appropriate under the circumstances the audit committee and its members should be vocal and visible. And when someone is proposing that something be added to the audit committee agenda, ask “what is it, what does it mean, what is expected of the audit committee in that regard and why, is the audit committee suited for that task, what does it require, what is needed, and is there someone else better suited, etc.?”

And as the audit committee is significantly dependent on other people to provide the committee and its members with information and advice, when the audit committee members understand their responsibilities, instead of being so dependent on other people to feed information, the committee and its members need to tell other people, such as the chief internal auditor, the external auditor, the CFO, the CEO, legal counsel, risk management, and important other people what the audit committee and its members expect of and need from them. But on the flip side, the flip side also ask the chief internal auditor, external auditor, CFO, CEO, risk management, legal counsel and people, “what do you believe should be on the audit committee's agenda, and why?” And, “is there anything else that you believe I should know about?” This also gives other important people the opportunity to shine, and helps to ensure that everyone is more on the same path. Of course simply getting back a laundry list of issues isn't helpful – there must be deliberate thought and consideration specific to the entity and its industry.

Board and audit committee members also need to have the appropriate demeanor under the circumstances at issue. The audit committee members have to be able to get along as a



committee and with others. But that doesn't mean to be a push over. In fact, just the opposite as an audit committee member it's okay and appropriate to also have a "Not on my watch" attitude toward errors and improprieties, although oversight cannot be expected to always catch everything. Personal reputation is important, and also being able to support and defend actions taken and not taken.

The following is a list of issues and topic areas to consider for discussion and evaluation. The list is intended to help trigger thought processes, but, of course, is not exhaustive as areas of discussion and evaluation will vary from entity to entity, industry to industry, and board and committee to board and committee. The following list does not suggest that each or any of the below issues and topics must be considered or covered and is not a checklist – instead, if your audit committee should consider all legally required functions and responsibilities, and the additional other responsibilities to which it has agreed.

- Audit committee meeting agenda preparation and dissemination process.
- Committee member independence, financial literacy, experience and expertise.
- Committee member access to information and/or education pertinent to the functions and responsibilities of the audit committee. Are the needs of the committee members being met, so that they are sufficiently knowledgeable and educated about the company or nonprofit and its industry; relevant significant accounting and auditing issues; relevant legal matters; internal controls, risk assessment and management; governance; and new developments in those and other areas?
- Committee and committee member interactions, including interaction between committee members, and between the committee and the board, the CEO, the CFO, the external auditor, the internal auditor, legal counsel, compliance and ethics, HR, consultants, and other people.
- The committee's processes for identifying and spotting issues, evaluation and decision making.
- The contents of the audit committee charter, and a mutual understanding of the audit committee's responsibilities and tasks. The charter is a requirement for public companies, and is a good idea for many private companies and nonprofit entities. The charter is a prudent document to identify and clarify the audit committee's responsibilities. In addition to the committee itself, it is important for the board, the executive officers, and other stakeholders to have a correct understanding about the committee's responsibilities and limitations, and the extent to which state or local jurisdiction, U.S. and international requirements and responsibilities apply or may apply to your audit committee.
- The audit committee's self-evaluation process.
- Selection of the outside auditor; audit planning; review of the performance of the outside auditor; and review of the quarterly review and annual audit report and process (or compilation if appropriate).

- Review and evaluation of the external auditor.
- Review of recent developments relating to standard of care and acceptable reliance on other people.
- Review of accounting and financial internal and fraud/embezzlement related controls and processes, risk assessment and management, possible entity and individual liability and reputation risk exposure; and compliance assessment and management relating to laws, regulations, and rules that are within the scope of the audit committee's functions and responsibilities including issues relating to the Foreign Corrupt Practices Act, suppliers and affiliates, etc.
- Review of the accounting department, and accounting and financial reporting for transactions including all of the subcomponents such as principles and policies applied (quality not just acceptability); judgments, estimates and reserves; timing and cutoff procedures; off balance sheet transactions; related party transactions; contingencies and liabilities; revenue recognition; expenses; inventories; goodwill; insider trading; and other matters relating to accounting and financial statement reports.
- Implementing the new revenue recognition rules.
- Review of the financial and internal audit functions, and how they can be helpful to the audit committee in the performance of its responsibilities and tasks.
- Review of risk or uncertainty assessment and management processes that are within the scope of the audit committee's functions and responsibilities.
- Internal controls, implementation and monitoring of COSO 2013 and improvements to be made.
- Documenting and reporting the audit committee's activities and minutes. This is a very important topic that might not get sufficient attention. Appropriate documentation helps the committee and its members to organize and perform their functions and responsibilities, and to defend their actions taken and not taken. Documentation that is below par isn't helpful and can be damaging.
- The audit committee's use of attorneys and consultants.
- The company's investor communication processes.
- Whistleblower, ethics and complaint handling processes; corporate investigations.
- Document retention policies.
- Review of the compliance and ethics function and processes that are within the scope of the audit committee's responsibilities, and how they can be helpful to the audit committee in the performance of its responsibilities and tasks.

- Governance and culture, including tone at the top, financial leadership, transparency and appearance.
- Review of employer, employee and workplace processes that are within the scope of the audit committee's function and responsibilities.
- Review of tax compliance and reporting issues that are within the scope of the audit committee's function and responsibilities.
- Review of cybersecurity within the scope of the audit committee's responsibilities. -Insurance.
- Review of pension and health plan related issues that are within the scope of the audit committee's function and responsibilities.
- Review of billing and accounting relating to the receipt of funds or revenue from governmental sources, including, for example Medicare and Medicaid; compliance with applicable laws, regulations, rules and other requirements; and oversight of expenses relating to these areas.
- Review of the acceptance, receipt, allocation, expenditure or distribution, and accounting for all charitable and donor funds, grants, contributions, pledges and other resources, including compliance with all requirements, restrictions and special uses.
- Review of accounting for collaboration and joint venture arrangements, including the allocation of receipts/income and distributions/expenses between the entities.
- And, in this economic environment, review of the fair value of funds and investments, including loss of value; liquidity concerns; possible going concern issues; estimates for uncollectibles and related reserves; debt/loan covenants; and funding source uncertainties including those that relate to collaboration and joint venture arrangements.
- It is also important for the audit committee to clarify with the board what responsibilities it has, if any, for oversight of the numerous and various areas of taxation and compliance; ERISA, pension and health and welfare plans; investments; tax exempt status including fund raising, dues, solicitation, and political, campaign and lobby activities; and other areas significant to the entity.
- Additional significant topics or issues that should be discussed.

[Hyperlink Back to Main Table of Contents](#)

## **XII AUDIT COMMITTEE AND BOARD SELF-EVALUATION**

Self-evaluation is an important board and committee activity. Although this discussion in this part is short in length, I have prepared and provide below links for two separate detailed self-evaluation papers to help you with your board and committee self-evaluations – one of the papers is for audit committee self-evaluation, and the other paper is for boards. Please do click

on the links for the papers which you will find on my blog. See also the discussion areas listed at part XI above.

1. Audit committee self-evaluation form link:  
<https://directorofficernews.files.wordpress.com/2013/09/audit-committee-self-evaluation-form-david-tate-esq-10302014.pdf>
2. Board self-evaluation form link:  
<https://directorofficernews.files.wordpress.com/2013/09/board-of-directors-annual-self-evaluation-form-david-tate-esq-10-30-14.pdf>

### **[Hyperlink Back to Main Table of Contents](#)**

## **XIII. NONPROFIT BOARDS AND AUDIT COMMITTEES (CALIFORNIA)**

The following materials apply to nonprofit board members in general and specifically in California, and also include materials about provisions of the California Nonprofit Integrity Act, risk management, and audit committees.

### **Overview of Contents:**

1. The Business Judgment Rule for California Nonprofits
2. The California Nonprofit Integrity Act
3. Nonprofit Risk Management Example
4. Nonprofit Audit Committees
5. Annual Self-Evaluation, Board and Committees (yes, and with an outside facilitator)

### **1. 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 therefore is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted. I have underlined part (3) above because it is important to understand that although a committee to which a task or responsibility has been delegated can do most of the work, the board still should receive a report or recommendation from the committee about the committee's important matters, prudently discuss and inquire about the report and/or recommendations, and approve them or refer for further work or considerations. In other words, the board should not simply punt decision making on important matters to the committee. Further, from a committee member's perspective, to ensure that everyone is on board and on the same page, I would want to make sure that the board is engaged, understands, and approves of the ongoing actions and recommendations of the committee close in time to when those actions and recommendations occur.

Thus, the business judgment standard for a board member of a nonprofit entity requires the director, including a board member who serves on a committee such as an audit committee member, to perform duties loyally, in good faith, without self-interest, in a manner that the director believes to be in the best interests of the entity, and with the care, including reasonable inquiry, as an ordinary prudent person in a like position would use under similar circumstances.

A director may not close his or her eyes to what is going on with respect to the entity's business and financial affairs. The director has a duty to be proactive. In relying on the opinions or reports of other people, the director also must act in good faith, conduct reasonable inquiry, and be free of any knowledge that would cause reliance on data and reports received from others to be unwarranted. "In a like position . . . under similar circumstances" refers to the situation that exists at that time, including the individual director's knowledge, experience and expertise. Thus, cases have held that a director who has specific expertise may be expected to use that expertise.

### **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 . . ."

Of course, the business judgment rule does not tell or educate a director about the specific tasks and actions to undertake to satisfy his or her director fiduciary duties. And except as otherwise discussed herein, those tasks and actions are too diverse and numerous to cover in this paper; however, in broad terms I characterize a director's duty as being a member of the board which is responsible for oversight of the entity's processes and functions pertaining to strategy, governance, accounting and financial statements, finance, risk management, compliance with laws, statutes, regulations and rules, and talent/succession.

## **2. The California Nonprofit Integrity Act**

### **Provisions Pertaining to Financial Statements, Audits and Audit Committees**

The entire board is responsible for oversight of the nonprofit's accounting system and financial statements, including if there is an audit of the financial statements; however, as discussed above, the board may delegate responsibility to a committee such as the audit committee, but with continuing board oversight. If the board delegates responsibilities to the audit committee, the board nevertheless should be informed about the significant activities and recommendations of the audit committee, and should approve those activities and recommendations.

The audit committee is a sub-committee of the board. Members of the audit committee are directors, as a general matter, although in one instance I served as an audit committee chair of a nonprofit but not as an overall board member where the nonprofit wanted a completely independent audit committee chair. As the business judgment rule applies to directors, the rule also provides a general standard of care for audit committee members. For the most part, the activities that a nonprofit audit committee is required to perform are unspecified. The committee's activities will depend on the financial size of the nonprofit, the requirements and expectations of the sources of funds (governmental and non-governmental), the type of outside auditor financial statement evaluation required (i.e., audit, review, compilation), and the expertise of the board and audit committee members. Depending on the circumstances, the financial statements of a nonprofit may require an audit (and possibly an enhanced government OMB A-133, or single audit), review or compilation, or a combination thereof. In California the Nonprofit Integrity Act provides additional statutory requirements.

With respect to nonprofit financial statements, audits and audit committees, the California Nonprofit Integrity Act at Cal. Gov. Code §12586 in part requires:

-Specified charitable corporations, unincorporated 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) to have annual financial statements, using generally accepted accounting principles, that are audited by an independent certified public accountant (adhering to the Government Auditing Standards, U.S. Comptroller General, Yellow Book) in conformity with generally accepted auditing standards. The Office of the Attorney General has stated that the audited financial statements and notes to the statements must be released to the public, but not the management letter which is not part of the audited financial statements; and that 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 corporation 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. The California Office of the Attorney General has stated that there is no requirement that the entity have a particular number of audit committee members—however, I suggest that there be three or more members to promote expertise, discussion, interaction and feedback.

-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.

-Subject to the supervision of the board, the audit committee shall recommend to the board 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 to satisfy its members 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 auditing firm conform with standards for auditor independence, and shall approve performance of any non-audit services by the auditing firm.

### **Provisions Pertaining to Executive Compensation**

California Government Code §12586(g) provides that the board of directors of a charitable corporation or an authorized committee of the board shall review and approve the compensation, including benefits, of the president or chief executive officer, and of the treasurer or chief financial officer to assure that it is just and reasonable. The review and approval shall occur initially upon hiring, whenever the term of employment is renewed or extended, and whenever the officer's compensation is modified. Separate review and approval is not required if a modification of compensation extends to substantially all employees. If the charitable corporation is affiliated with other charitable corporations, the review and approval requirements will be satisfied if review and approval is obtained from the board or from an authorized committee of the board of the charitable corporation that makes the retention and compensation decisions about the officer in question.

### **Provisions Pertaining to Fundraising**

California Government Code §§12599 through 12599.7 contain detailed requirements pertaining to certain fundraising activities. The following is an overview of the provisions.

-Commercial fundraisers must notify the California Attorney General before starting a solicitation campaign.

-Commercial fundraisers for charitable purposes must report and provide required information to the Attorney General's Registry of Charitable Trusts the start of a solicitation

campaign or event not less than 10 working days prior to the start of a solicitation campaign or event or no later than the date on which the campaign begins if the proceeds are intended for victims of disasters or emergencies.

-For every solicitation campaign or event produced by a commercial fundraiser for a charitable organization, there must be a written contract, satisfying specific statutory terms and requirements, between the fundraiser and the charitable organization.

-The contract must be signed by the commercial fundraiser's authorized contracting officer and an official of the charitable organization authorized to sign by the governing board.

-Contracts between commercial fundraisers for charitable purposes and charitable organizations are voidable unless the commercial fundraiser is registered with the Attorney General's Registry of Charitable Trusts prior to the start of the solicitation campaign or event.

-Fundraising counsel must file a notice and provide information with the Attorney General's Registry of Charitable Trusts not less than 10 working days prior to the start of a solicitation campaign or event; or if the purpose is to raise funds for victims of disasters or emergencies, no later than the date on which the campaign begins.

-For every solicitation campaign or event, there must be a written contract, satisfying specific statutory terms and requirements, between the fundraising counsel and the charitable organization. The contract must be signed by the fundraising counsel's authorized contracting officer and an official of the charitable organization authorized to sign by the governing board.

-Charitable organizations have the right to cancel a contract with a commercial fundraiser without liability for 10 days following the date the contract is executed.

-Following the initial 10-day period, charitable organizations have the right to cancel a contract with a commercial fundraiser by providing 30-day notice. The charitable organization is liable for services provided by the commercial fundraiser up to 30 days after the notice is served.

-Following the initial 10-day period, a charitable organization has the right to cancel a contract with a commercial fundraiser without liability if the commercial fundraiser or its agents make material misrepresentations during a solicitation, harm the charitable organization's reputation during a solicitation, or are found to have been convicted of a crime arising from fundraising activities.

-Charitable organizations and commercial fundraisers cannot misrepresent the purpose of a charitable organization, or the nature or purpose of the beneficiary of a solicitation.

-Charitable organizations must establish and exercise control over fundraising activities conducted for their benefit. This obligation includes approving all written contracts and agreements, and assuring fundraising activities are conducted without coercion.



-Charitable organizations cannot enter into any contract or agreement with a commercial fundraiser that is not registered with the Attorney Generals Registry of Charitable Trusts.

-Charitable organizations cannot raise funds for any charitable organization required to be registered with the Attorney Generals Registry of Charitable Trusts unless the charitable organization is so registered or, if not, agrees to register prior to the start of a solicitation.

-Commercial fundraisers must, within five working days, either deposit in a bank account controlled by the charitable organization or deliver personally to the charitable organization all contributions received on behalf of the charitable organization.

-The following acts are prohibited in the planning, conduct or execution of solicitation campaigns:

-Operating in violation of the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Cal. Gov. Code §12580, et seq.), regulations and orders issued by the Attorney General.

-Committing unfair or deceptive acts, or engaging in fraudulent conduct.

-Using any name, symbol, emblem or other information that falsely suggests or implies a contribution is for a particular charitable organization.

-Falsely telling donors that a contribution is for a charitable organization or will be used for a charitable purpose.

-Telling donors that a person sponsors, endorses or approves a charitable solicitation when that person has not agreed in writing to have their name used for such a purpose.

-Misrepresenting that goods or services have endorsements, sponsorships, approvals, characteristics or qualities they do not have.

-Misrepresenting that a person has endorsements, approvals, sponsorships, status or affiliations they do not have.

-Misrepresenting that registration with the Attorney Generals Registry of Charitable Trusts constitutes an endorsement or approval by the Attorney General.

-Representing that a charitable organization will receive an amount greater than the reasonably estimated net proceeds from a solicitation campaign or event.

-Issuing cards, stickers, emblems, plates or other items that can be used for display on a motor vehicle, and which suggest an affiliation with, or endorsement by, public safety personnel or a group of public safety personnel.

-Representing that any portion of contributions solicited by a charitable organization will be given to another charitable organization unless the second charitable organization provides prior written consent for such use of its name.

-Representing that tickets to events will be donated for use by another person or entity unless: the charitable organization or commercial fundraiser has obtained written commitments from charitable organizations that they will accept a specific number of donated tickets; and the donated tickets, when combined with other ticket donations, do exceed either the ticket donations received from charitable organizations or the total capacity of the event site.

-Commercials must maintain for at least 10 years following each solicitation campaign records that contain:

-The date and amount of each cash contribution.

-The date, amount, name and address of each non-cash contributor.

-The name and address of each employee or agent involved.

-Documentation of all revenue received and expenses incurred.

-For each account into which the fundraiser deposited revenue, the account number and name and location of the bank or other financial institution in which the account was maintained.

### **3. Nonprofit Risk Management Example**

Risk management as a topic area is discussed above at part X; however, I thought it worthwhile to also include for nonprofits the following two paragraph example for illustration purposes.

We don't want to get bogged down in a technical discussion about risk management as the objective here is to encourage the organization to consider and improve upon its risk management processes. For the purpose of an exercise, let's take the example of a hypothetical nonprofit that provides assistance to people in need who are of low or no income. In part, the nonprofit runs a care clinic. The clinic is staffed with volunteers and with licensed care professionals who provide their time and services at a reduced rate. The nonprofit primarily receives revenue/receipts from donations, from a government contract with the city which pays for care provided to qualifying patients who access the clinic on a per-patient basis (the city contract covers a little over half of the costs of operating the clinic), and from insurance and public benefit reimbursements. The nonprofit's mission is also in part religious.

Some of the nonprofit's objectives and risks that quickly come to mind are: securing a timely stream of revenues/receipts/donations from the various available sources; identifying the care that will be provided and maintaining the quality and timeliness of diagnosis and care; proper discharge and/or referral of patients; satisfying the specific requirements of the contract with the city; medical record security and privacy; satisfying HR requirements; satisfying legal

requirements and adopting compliance programs and processes; maintaining the religious aspect of the organization's mission; obtaining appropriate liability and risk insurance coverage; and proper and timely transaction recording, accounting records, internal controls and financial reports and statements.

#### **4. Nonprofit Audit Committees**

Oversight of the accounting function and the financial statements is a board function. Some nonprofit boards have audit subcommittees, some don't and in California some are required to have audit committees pursuant to the Nonprofit Integrity Act. There is very little guidance that specifies how a nonprofit board or audit committee should go about satisfying the accounting function and financial statement oversight. Just for example, some nonprofits have or are required to have their financial statements audited such as pursuant to the Nonprofit Integrity Act, whereas other nonprofits are not required to have audits and may or may not have their financial statements reviewed or compiled. Depending on the circumstances and the type or amount of governmental receipts or revenues that the nonprofit receives, the financial statements of a nonprofit also may require an enhanced government OMB A-133, or single audit. And nonprofits also generally don't have internal audit functions which could help the audit committee with its oversight function.

So how does a nonprofit audit committee go about satisfying its oversight function? First, I recommend that there be an audit committee charter. A real charter which lists what the audit committee will do and oversee, and in appropriate circumstances items or functions that the audit committee will not perform or oversee. For example, if the audit committee is designated as being responsible for risk management oversight and reporting back to the board about risk management, the charter and the stakeholders such as the board members, the audit committee, the CFO and/or Controller, the CEO or President and other involved people need to understand exactly what that oversight covers.

The audit committee should want to be comfortable that the people who are performing the CFO, Controller, accounting and financial statement tasks and functions are qualified and are performing their tasks and functions properly.

The audit committee should want to be comfortable that internal controls in place are sufficient and excellent. I don't want to get too complicated in this discussion, but take a look at COSO 2013 at part VIII above.

The audit committee should want to be comfortable that the external auditor, if there is one, is performing those services with excellence. An audit committee member isn't involved in the day-to-day operations, the design, implementation or monitoring of the internal controls, the recording of accounting entries, or the preparation of the financial statements. The board, and the audit committee and its members truly are dependent on the outside auditor doing an excellent job.

Obviously an audit committee member must have sufficient assertiveness, time availability, knowledge and experience to know what she or he is doing, to ask necessary

questions, to make decisions, and to oversee the outside auditor and all of the people listed above who are involved in the accounting and financial statement function. This also requires that an audit committee member has to understand the services that are supposed to be performed by the outside auditor, and that are being performed, and be qualified to discuss those matters with the outside auditor in addition to the communications that the outside auditor is required to have with the audit committee and its members.

The following is a summary of discussions that the external auditor should consider and in appropriate circumstances have with the board and/or audit committee when an audit is performed by the external auditor. Different requirements apply when the auditor performs a review or compilation engagement. The following summary is based on topics that are covered in various of the Statements on Auditing Standards. See also the more detailed discussions above at parts VI Audits, Reviews and Compilations, VII Audit Committee Evaluation of the External Auditor, and VIII Internal Controls.

-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.

-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.

-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.

-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.

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 components of internal control. See also COSO 2013.

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.

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.

With respect to evaluating the participation of those charged with governance the auditor should consider: (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.

The outside auditor is required to evaluate whether a deficiency in internal control is significant enough to require communication of the deficiency to the audit committee. A significant internal control deficiency, or a lack of appropriate corrective response by management to a material deficiency, may raise doubt about the integrity of management, and whether it is possible to audit the financial statements.

-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;

-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.

Significant control deficiencies or material weaknesses in control identified during the audit must be communicated in writing to management and to the audit committee (and perhaps the board), including significant deficiencies and material weaknesses that were communicated in the previous audits, and that have not yet been remedied. The auditor's responsibility to communicate significant deficiencies and material weaknesses exists even if there has been a decision by management or those charged with governance to accept that degree of risk.

A significant deficiency is a control deficiency or combination of control deficiencies that adversely affects the company's ability to initiate, authorize, record, process or report financial data reliably in accordance with generally accepted accounting principles such that there is more than a remote likelihood that a misstatement of the entity's financial statements that is more than inconsequential will not be prevented or detected.

A material weakness is a significant deficiency or combination of significant deficiencies that results in more than a remote likelihood that a material misstatement of the financial statements will not be prevented or detected. A misstatement is inconsequential if a reasonable person would conclude, after considering the possibility of further undetected misstatements, that the misstatement, individually or when aggregated with other misstatements, would clearly be qualitatively and quantitatively immaterial to the financial statements.

See also, the discussion above at part VI Audits, Reviews and Compilations.

### **5. Annual Self-Evaluation, Board and Committees**

Should the board and its committees have or perform an annual self-evaluation? The short answer, yes. It is good for the members to consider the positive aspects of the board's activities and processes, and possible improvements including additional or different information, processes and education that might be helpful to the board members. No particular self-evaluation process is required. You can find both board and audit committee self-evaluation materials in my other writings. I also recommend that you use an outside facilitator to help with your evaluation process – although self-evaluation without a facilitator can be beneficial, as you can probably imagine evaluation without a facilitator it is likely to be less productive. See the specific discussion about this topic with links to forms at part XII above.

[Hyperlink Back to Main Table of Contents](#)

## **XIV. INVESTIGATIONS; CONFLICTS OF INTEREST; SPECIAL COMMITTEES**

Internal corporate investigations and reviews have become much more common, particularly in situations involving possible unlawful activities or unacceptable risk exposure, including both quantitative and qualitative risk. The circumstances in which an investigation or review might be warranted are numerous and diverse, including, for example, situations involving corporate derivative litigation, or possible fraud, accounting impropriety, misappropriation, misrepresentation, self-dealing, workplace discrimination or harassment, bribery, and other unlawful acts. Members of the audit committee and other independent directors often are naturally considered to serve on investigation or review committees.

It is beyond the scope of these materials to discuss this topic in detail. However, members of a special committee or panel should consider the sufficiency of their own independence and qualifications to serve, and the independence and qualifications of counsel and consultants that they engage for representation and assistance. There have been several cases involving special committee member independence issues. A prospective special committee member who lacks independence from either the person or the situation being investigated or reviewed is incompetent to serve as a committee member. When evaluating the issue of independence, courts now are evaluating all direct and indirect relationships and associations, including not only business and family relationships, but also social relationship activities including clubs and other associations. The following are examples of cases involving conflicts of interest. See, e.g., *In re Walt Disney Co. Derivative Litig.* (Del Ch 2003) 825 A2d 275 (CEO and President had 25-year friendship); *In re Oracle Corp. Derivative Litig.* (Del Ch 2003) 824 A2d 917, 921 (ties that board directors and special litigation committee members had to one university as alumni, tenured faculty professors, very major contributors, etc. were "too substantial for this court to ignore"); *Biondi v Scrushy and HealthSouth Corp.* (Del Ch 2003) 820 A2d 1148 (CEO who was target of derivative lawsuit served on board of National Football Foundation and College Hall of Fame, Inc. with both members of special litigation committee; in addition, CEO and one member of the special litigation committee were both large contributors to college sports programs in Alabama, and a stadium at one college was named after both of them).

See U.S. DOJ link to Caldwell speech about expectations in corporate investigations, <http://www.justice.gov/opa/speech/assistant-attorney-general-leslie-r-caldwell-delivers-remarks-compliance-week-conference>

I will be adding to these materials. For now, the following are two additional links to materials on the topic of special committees:

1. <http://www.haynesboone.com/news-and-events/news/alerts/2011/07/15/what-is-a-special-committee-of-the-board-of-directors-and-when-does-our-company-need-one>
2. [http://www.rbh.com/files/Publication/3c95c25b-7cf9-423c-a2e4-b8ccfff05650/Presentation/PublicationAttachment/038fd94b-d10c-42e7-bec1-21105512b227/Article\\_pbuck\\_BizLawInstitute.pdf](http://www.rbh.com/files/Publication/3c95c25b-7cf9-423c-a2e4-b8ccfff05650/Presentation/PublicationAttachment/038fd94b-d10c-42e7-bec1-21105512b227/Article_pbuck_BizLawInstitute.pdf)

[\*\*Hyperlink Back to Main Table of Contents\*\*](#)

## **XV. ADDITIONAL COMPLIANCE MATERIALS; FCPA; ETC.**



This obviously is a broad topic area. I will be adding to these materials including links to materials by other people.

### The Key Components of an Organizational Compliance Program

The following are key organizational compliance program component areas. Of course, each component must also have subparts, and program standards and procedures must be developed to meet the needs of the specific organization for potential different substantive areas such as the foreign corrupt practices act; governmental billings and receipts; fraud; HR and the ADA; accounting; disclosures; environmental; quality assurance (such as with respect to products, materials, services or care); bribes/kickbacks; and other areas of potential liability and risk exposure.

- High-level personnel of the organization (tone at the top) must ensure that the organization has an effective compliance and ethics program. A specific individual, or individuals, within high-level personnel shall be assigned overall responsibility for the compliance and ethics program. The term "high-level personnel of the organization" means individuals who have substantial control over the organization or who have a substantial role in the making of policy within the organization. The term includes: a director; an executive officer; an individual in charge of a major business or functional unit of the organization, such as sales, administration, or finance; and an individual with a substantial ownership interest.
- The organization's governing authority, i.e., the Board or other highest-level governing body (tone at the top) shall be knowledgeable about the content and operation of the compliance and ethics program and shall exercise oversight with respect to implementation and effectiveness.
- A specific individual, or individuals, within the organization shall be delegated day-to-day operational responsibility for the compliance and ethics program, and shall report periodically to high-level personnel and to the governing authority, or an appropriate subgroup of the governing authority, on the effectiveness of the compliance and ethics program. The person or persons to whom responsibility is delegated shall be given adequate resources, appropriate authority, and direct access to the governing authority or an appropriate subgroup of the governing authority.
- Delineate lines of reporting and authority that are designed to effectively accomplish the goals and objectives of the compliance and ethics program.
- Design the compliance and ethics program standards and procedures to prevent and detect criminal conduct.
- Implement the standards and procedures.
- Promote and incentivize the compliance and ethics program consistently throughout the organization, and promote an organizational culture of ethical conduct and compliance with laws, regulations and rules. Periodically communicate the program's standards and procedures, and other aspects of the compliance and ethics program, to the members of the governing authority, high-level personnel, substantial authority personnel, the organization's employees,

and, as appropriate, the organization's agents. The term "substantial authority personnel" means individuals who within the scope of their authority exercise a substantial measure of discretion in acting on behalf of an organization. The term includes high-level personnel of the organization, individuals who exercise substantial supervisory authority (e.g., a plant manager, a sales manager), and any other individuals who, although not a part of an organization's management, nevertheless exercise substantial discretion when acting within the scope of their authority (e.g., an individual with authority in an organization to negotiate or set price levels or an individual authorized to negotiate or approve significant contracts).

- Monitor the program to ensure that it is being followed to prevent and detect criminal conduct. Review and improve the program when needed.
- Periodically audit and evaluate the effectiveness of the standards and procedures to prevent and detect criminal conduct. Review and improve the program when needed.
- Periodically assess and reassess the risk of criminal conduct and take appropriate steps to design, implement, or modify each requirement in the program to reduce the risk of criminal conduct identified through this process.
- Have and enforce an effective progressive disciplinary system to encourage compliance with the goals and objectives of the compliance and ethics program.
- Enforce the compliance and ethics program's standards and procedures consistently throughout the organization including appropriate disciplinary measures for engaging in criminal conduct and for failing to take reasonable steps to prevent or detect criminal conduct.
- Implement policies and procedures to facilitate prompt appropriate organizational reaction to possible unlawful conduct, and potential damage mitigation, control and remedy.
- After potential or actual criminal conduct has been detected, take necessary steps to promptly and appropriately respond to and investigate the conduct and to prevent further similar conduct, including making any necessary modifications to the organization's compliance and ethics program.
- Have and publicize a system, which includes mechanisms that allow for anonymity or confidentiality, whereby the organization's employees and agents may report or seek guidance regarding potential or actual criminal conduct without fear of retaliation.

[Hyperlink Back to Main Table of Contents](#)

## **XVI. POSSIBLE ADDITIONAL TOPICS/ISSUES – JUST A NOTE FOR REFERENCE**

*This section essentially simply lists other issues or topics for my further consideration.*

Additional materials from the Securities and Exchange Commission (SEC), SEC website <http://www.sec.gov/>

Additional materials from the Public Company Accounting Oversight Board (PCAOB), standards, PCAOB website and pronouncements (add the important pronouncements) <http://pcaobus.org/Standards/Pages/default.aspx>

Cybersecurity / risk management, Framework for Improving Critical Infrastructure Cybersecurity, NIST – National Institute of Standards and Technology. More discussion about cybersecurity protection and risk management as this is a topic that might be delegated to the audit committee and the CFO, and it has become a very important topic for liability, reputation, crisis management, and keeping clients and customers.

Add an insurance topic area. D&O, business, cybersecurity, etc. Add Tate article about D&O insurance for CalCPA.

SOX 404 requirements.

Internal audit and the IIA – the new guidance and pronouncements, strategy and risk.

Accounting Pronouncements, GAAP, IFR, etc.

Materials or Links from the external auditing firms, internal audit and outside consulting firms.

Center for Audit Quality (Affiliated with the AICPA), CAQ website <http://www.thecaq.org/>.

Sample Audit Committee Charter form.

Additional materials from the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Additional risk management, ERM, and internal control materials.

The UK Serious Fraud Office.

Checklists in the 2007 chapter.

Add a section on recent developments and news.

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[Hyperlink Back to Main Table of Contents](#)