

Guide for Audit Committees

James Hamilton
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Introduction

“The audit committee is the most established and clearly defined of all board committees. It is the primary link between the company’s board of directors and its outside auditors.”

“.. the audit committee’s function is based, in part, on its ability to carry out the necessary level of due diligence, relying on experts such as the chief financial officer, internal auditor, and independent external auditors. And then, with counsel from its legal advisors, the audit committee should document the process it followed, the conclusions it reached, and the basis for those conclusions in and appropriate fashion, such as in the committee charter and minutes.”

Committee’s Composition and Duties

“Sarbanes-Oxley Act requires audit committees to be directly responsible for the appointment, compensation, and oversight of the work of auditors, and requires auditors to report directly to the audit committee.”

“The act requires audit committees to have in place procedures to receive and address complaints regarding accounting, internal control, or auditing issues. Further, it provides protection for corporate whistle blowers”

“The act also requires public companies to provide their audit committees with authority and funding to engage independent counsel and other advisors as they determine necessary in order to carry out their duties.” This should include funding for independent auditors.

Two basic criteria for audit committee independence 1) not accepting a fee from the company (other than in the member’s capacity as a member of the board or board committee or payments made in general to a class i.e. capital credits distributions) and 2) not being affiliated with the company.

“To promote auditor independence, the auditor should be hired, evaluated and, if necessary, terminated by the audit committee.”

“... SEC rules provide that the audit committee is directly responsible for the appointment, compensation, retention, and oversight of the work of any public accounting firm engaged to prepare or issue and audit report ...”

“The independent auditor will report directly to the audit committee.”

Guide for Audit Committees

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“SEC rules require audit committees to establish procedures for:

- The receipt, retention, and treatment of complaints received by the company regarding accounting, internal accounting controls or auditing matters; and
- The confidential, anonymous submission by company employees of concerns regarding questionable accounting or auditing matters.”

“SEC rules specifically authorize the audit committee to engage outside advisors, including counsel, as it determines necessary to carry out its duties”

“SEC rules mandate that the company must provide funding to the audit committee in three distinct areas:

- To compensate any public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the company
- To pay any advisors employed by the audit committee
- To fund ordinary administrative expenses of the audit committee that are necessary or appropriate in carrying out its duties.”

Internal Controls

According to the SEC, the purpose of internal controls and procedures is to provide reasonable assurance that

- Transactions are properly authorized
- Assets are safeguarded against unauthorized or improper use
- Transactions are properly recorded and reported

Evaluation of internal controls includes but is not limited to;

- Controls over initiating recording, processing and reconciling account balances, classes of transactions and disclosure and related assertions included in the financial statements;
- Controls related to the initiation and processing of non-routine and non-systematic transactions;
- Controls related to the selection and application of appropriate accounting policies;
- And controls related to the prevention, identification, and detection of fraud.”

“Implementing Sarbanes-Oxley, SEC rules require independent public auditors to attest to and report on management’s assessment of the effectiveness of the company’s internal control over financial reporting.”

Guide for Audit Committees

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Audit Committee Financial Expert

“The Sarbanes-Oxley Act directed the SEC to adopt rules requiring the disclosure of whether a company has at least one financial expert on its audit committee, and if not the reasons why. Attributes the SEC must consider in defining financial expert are:

- An understanding of generally accepted accounting principles and financial statements;
- 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;
- Experience with internal accounting controls; and
- An understanding of audit committee functions.”

“The SEC adopted a two-part definition of “audit committee financial expert.”

“First, to be an audit committee financial expert, a person must have the following attributes:

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

Second, a person must have acquired these attributes through certain means. Specifically, the person must have gained financial expertise through any one or more of the following:

- Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;
- Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor, or person performing similar duties;

Guide for Audit Committees

James Hamilton
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- Experience overseeing or assessing the performance of company or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
- Other relevant experience.”

Report, Charter and Proxy Disclosure

“The rules (SEC) require that companies include reports of their audit committees in their proxy statements. . . . the report must state whether the audit committee, among other things, reviewed and discussed the audited financial statements with management, discussed certain matters with the auditors (including obtaining from the auditors disclosures regarding the auditors’ independence required by Independence Standards Board Standard No. 1 and discussed the auditors’ independence), and recommended that the board include the audited financial statements in the company’s annual report.”

The audit committee best practices charter should;

- “Be written and tailored to the company environment
- Clearly indicate committee duties and responsibilities
- Be carefully reviewed and approved by the board of directors and periodically challenged and updated by the committee or board or both
- Define the background and experience requirements for committee members
- Define the committee’s authority and specific responsibilities, particularly those relative to business and financial risk identification and related controls, compliance with laws and regulations, and oversight of internal and external audit activities
- Set guidelines for the committee’s relationships/meetings with members of the management team, internal/external auditors, and others as appropriate
- Set the frequency and general timing of meetings, allowing adequate time for preparation of substantive reporting to the full board
- Define the committee’s accountability and reporting requirements to the board and to the shareholders
- Provide the authority for access to internal and external resources as the committee may require
- Be reviewed, with input from appropriate members of management, auditors and counsel.”

Report to Audit Committee

“Sarbanes-Oxley requires an accounting firm performing an audit to report in a timely manner to the company’s audit committee:

- The critical accounting policies and practices to be used

Guide for Audit Committees

James Hamilton

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- All alternative treatments of financial information within GAAP that have been discussed with management
- Any accounting disagreements between the auditor and management
- Other material written communications between the auditor and management”

Guide for Audit Committees

James Hamilton
Ted Trautmann

Auditor Independence

“Sarbanes-Oxley prohibits the auditor of the company’s financial statements from providing certain non-audit services for the company and permits other non-audit services to be performed on if the service is pre-approved by the audit committee.”

“ ... audit committees to be directly responsible for the appointment, compensation, and oversight of the work of auditors, and requiring auditors to report directly to the audit committee.”

Audit Partner Rotation

“The Act also requires rotation of certain audit partners on a five-year basis in order to continue to provide audit services for a company.”

“ .. at a minimum, two partners be subject to rotation: the lead audit partner and the concurring partner. The SEC rules subject the lead and concurring partners to a five-year “time out” period.”

Improper Influence on Auditors

Both Sarbanes-Oxley and SEC rules “prohibit a company’s officers or directors, or persons acting under their direction, from coercing, manipulating, misleading, or fraudulently influencing the auditor of the financial statements for the purpose of rendering such financial statements materially misleading.”

Attorney Reporting Duty

Sarbanes-Oxley requires an attorney, either in house or outside hire, “to report evidence of a material violation of securities laws or breach of fiduciary duty or similar violation by the company or any of its agents to the company’s chief legal counsel or chief executive officer. If the CLO or CEO does not respond appropriately to the evidence, the attorney must report the evidence to the audit committee, another committee of independent directors, or the full board of directors.”

Best Practices

- Internal Controls
- Auditor Independence
- Key Monitoring Role
- Candid Discussions
- Diligent Committee Membership

Guide for Audit Committees

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Other Considerations

- Materiality – misstated or omission of relevant facts, which would change an investors view. Types of information or events that are potentially material include
 1. Earnings information
 2. Mergers, acquisitions, tender offers, joint ventures, or changes in assets
 3. New products or discoveries, or developments regarding customers or suppliers
 4. Changes in control or management
 5. Changes in auditors or auditors notification that the company can no longer rely on the auditors report
 6. Events regarding the company's securities (e.g. defaults on senior securities, calls of securities for redemption, repurchase plans, stock splits or changes in dividends, changes to shareholder rights, or public or private sales of additional securities) and
 7. Bankruptcies or receiverships

- Business Judgment Rule

“The decisions of directors and officers in managing the company may not be attacked so long as the directors acted in good faith and used their best business judgment. The rule is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. The rule contains five key elements:

 1. A business decision
 2. Disinterestedness
 3. Due care
 4. Good faith; and
 5. No abuse of discretion”