AUDIT COMMITTEE RESPONSIBILITIES & RISK MANAGEMENT

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Dave Tate, CPA, Esq.
San Francisco, CA
http://davidtate.us
tateatty@yahoo.com

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I. INTRODUCTION

These materials cover essential public and private company audit committee functions and responsibilities in a quick-read summary format. Audit committees are regulated or impacted by numerous statutes, cases, rules, regulations and pronouncements. While some audit committee responsibilities are mandatory, other committee functions and responsibilities are discretionary depending on the circumstances. Although an increasing number of the functions and responsibilities are specified by statute, rule or regulation, an audit committee's standard of care remains significantly dependent on due diligence and prudent judgment.

Please note, the materials in this paper are simplified and summarized. Case law discussions, and formal citations have also been omitted. Detailed legal and technical discussions can be found in other materials written by the author. For additional information, see also, http://davidtate.us.

The materials in this paper do not provide legal, accounting or other professional advice. These materials are not a solicitation for work. The materials do not apply to any particular person, entity, event, transaction or situation. These materials are only a summary. 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 the summary materials in this paper. The materials in this paper are update and changed periodically, and cannot be relied upon for that additional reason.

II. THE BUSINESS JUDGMENT RULE

The audit committee is a sub-committee of the board. Members of the committee are directors. Thus, the business judgment rule provides a standard of care for the audit committee.

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

- In good faith, with honesty and without self-dealing or improper personal benefit;

-In a manner that the committee member believes to be in the best interests of the corporation and its shareholders; and

-With the care, including reasonable inquiry, that an ordinarily prudent person in a like position would use under similar circumstances.

The director or audit committee member is entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, prepared or presented by any of the following:

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

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

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

Court cases that discuss audit committee or director responsibilities highlight duties and responsibilities to proactively exercise due diligence, spot red flags, and address issues. Cases are contained in other separate materials.

III. AUDIT COMMITTEE COMPOSITION

The following discussion is an overview of the federal statues, related rules and regulations, and stock exchange provisions that have been enacted to specify audit committee member composition and qualification requirements for U.S. domestic companies that are issuers of securities listed on a national securities exchange or an interdealer quotation system of a national securities association. The requirements in various circumstances may be different for other entities.

A. Federal Statutes, and Related Rules and Regulations

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

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

-An understanding of generally accepted accounting principles and financial statements;

-Experience in the preparation or auditing of financial statements of generally comparable companies, and the application of generally accepted accounting principles in connection with accounting for estimates, accruals, and reserves;

-Experience with internal accounting controls; and

-An understanding of audit committee functions.

SEC Regulation S-K, Item 407 further defines the qualifications necessary to be a "financial expert."

SEC Rule 10A-3. In pertinent part with respect to audit committee member composition, SEC Rule 10A-3 of the Securities and Exchange Act of 1934 (Securities Exchange Act) requires that each audit committee member be a member of the board of directors, and be independent.

B. Stock Exchange (SRO) Rules

1. NYSE Listed Company Manual

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

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

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

2. NASDAQ Stock Market Rules

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

3. American Stock Exchange Company Guide

The American Stock Exchange maintains similar audit committee composition and member qualification requirements. See American Stock Exchange Company Guide at §803.

IV. AUDIT COMMITTEE FUNCTIONS AND RESPONSIBILITIES

The following discussion covers audit committee functions and responsibilities that are specified or required by statute, rule or regulation. However, the business judgment rule always also still applies with respect to the audit committee's satisfaction of its functions and responsibilities, and should be viewed as the general standard requiring due diligence, etc., in all circumstances.

A. Federal Statutes and Related Rules and Regulations

Public Company Audit Committees. With respect to audit committees of public companies, Sarbanes-Oxley §301 requires that:

> -The audit committee, in its capacity as a committee of the board of directors, is responsible for the appointment, compensation, and oversight of the work of the outside auditor (including resolution of disagreements between management and the auditor regarding financial reporting).
>
> -The outside auditor must report directly to the audit committee.
>
> -The audit committee is authorized to hire independent counsel and other advisers to help the committee perform its duties.
>
> -The audit committee must establish procedures for the receipt, retention, and treatment of

complaints received by the company regarding accounting, internal accounting controls, or auditing matters; and for confidential, anonymous submission by company employees of concerns regarding questionable accounting or auditing matters. SEC Regulation S-K, Item 407 also requires that there be a process for shareholders to communicate with the board.

-The company must provide appropriate funding, as determined by the audit committee, for compensation of the outside auditor employed for the purpose of issuing an audit report.

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

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

Improper Influence on the Conduct of Audits. Sarbanes-Oxley §303 makes it 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.

Management Assessment of Internal Controls. Sarbanes-Oxley §404 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 contains 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. SEC guidance in part revises 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 to define the term

"material weakness" as "a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected on a timely basis."

Generally, 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.

SEC Regulation S-K, Item 308, requires management's annual report on the company's internal control to contain a statement of management's responsibility for establishing and maintaining adequate internal control; a statement identifying the framework used by management to evaluate the effectiveness of the company's internal control over financial reporting; management's assessment of the effectiveness of the company's internal control over financial reporting; and a statement that the outside auditor that audited the financial statements has issued an attestation report pertaining to internal control over financial reporting. SEC Regulation S-K, Item 308 also requires the disclosure of any change in the company's internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting.

Code of Ethics for Senior Financial Officers. Sarbanes-Oxley §406 directs the SEC to issue rules requiring each issuing company to disclose whether or not the company has adopted a code of ethics for senior financial officers, and if the company has not, the reason why not.

Real Time Issuer Disclosures. Sarbanes-Oxley §409 requires each issuing company to disclose to the public on a rapid and current basis additional information concerning material changes in the financial condition or operations of the company, in plain English, as the SEC determines is necessary or useful for the protection of investors and in the public interest. See also Regulation S-K, Item 307, requiring the company to disclose the conclusions of the company's principal executive and principal financial officers regarding the effectiveness of the company's disclosure controls and procedures. The term "disclosure controls and procedures," is defined to mean controls and other procedures designed to ensure that information required to be disclosed by the company in the reports that it files or submits under the is timely and accurately recorded, processed, summarized and reported.

Whistleblower and Anti-Retaliation Protections

Whistleblower Protection for Employees of Publicly Traded Companies. Pursuant to Sarbanes-Oxley §806, no issuing company, or any company officer, employee, contractor, subcontractor may discharge, demote, suspend, threaten, harass, or in any other manner discriminate against an employee because of any lawful act done by the employee to provide information or assist in an investigation regarding any conduct which the employee reasonably believes constitutes a violation of any rule or regulation of the SEC, or any provision of federal law relating to fraud against shareholders.

Anti-Retaliation Against Informants. Pursuant to Sarbanes-Oxley §1107, it is unlawful for a person to knowingly and with the intent to retaliate, take any action harmful to any person, including interference with the employment or livelihood of the person, for providing to a law enforcement

officer any truthful information relating to the actual or possible commission of a federal offense.

Auditor Independence and Services

Services Outside the Scope of Practice of Auditors. Sarbanes-Oxley §201 provides that a public accounting firm may not provide to an issuer contemporaneously with the audit, any non-audit service, including:

- Bookkeeping or other services related to the accounting records or financial statements of the audit client;

-Financial information systems design and implementation;

-Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;

-Actuarial services;

-Internal audit outsourcing services;

-Management functions or human resources;

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

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

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

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

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

Audit Partner Rotation. A public accounting firm may not provide audit services to an issuer company if the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit, has performed audit services for that company in each of the five previous fiscal years. See Sarbanes-Oxley §203.

Auditor Report to Audit Committee. Sarbanes-Oxley §204 requires that the outside auditor timely report to the audit committee:

-All critical accounting policies and practices to be used;

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

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

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

SEC Rule 10A-3. In pertinent part with respect to functions and responsibilities, Rule 10A-3 of the Securities Exchange Act requires that:

-The audit committee, in its capacity as a committee of the board, is responsible for the appointment, compensation, retention and oversight of the outside auditor (including resolution of disagreements between management and the outside auditor).

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

-The audit committee has authority to engage independent counsel and other advisors.

-The company issuer shall provide the funding that is determined necessary by the audit committee to compensate the outside auditor, compensate advisors employed by the audit committee, and pay the administrative expenses of the audit committee.

B. Stock Exchange (SRO) Rules

1. NYSE Listed Company Manual

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

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

The audit committee must have a written charter that addresses:

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

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

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

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

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

-At least annually, obtain and review a report by the outside auditor describing: (1) the firm's internal quality-control procedures; (2) any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, and any steps taken to deal with any such issues; and (3) to assess the auditor's independence and all relationships between the outside auditor and the company. Commentary to §303A.07 states that the audit committee should evaluate the auditor's qualifications, performance and independence.

-Discuss the company's annual audited financial statements and quarterly financial statements with management and the outside auditor, including reviewing the company's disclosures under Management's Discussion and Analysis of Financial Condition and Results of Operations.

-Discuss the company's earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies.

-Discuss policies with respect to risk assessment and risk management.

-Meet separately and periodically with management, with the internal auditors (or other personnel responsible for the internal audit function) and with the outside auditor.

-Review with the outside auditor any audit problems or difficulties and management's response.

-Set clear hiring policies for employees or former employees of the outside auditor.

-Report regularly to the board of directors, and review with the full board any issues that arise with respect to the quality or integrity of the company's financial statements, the company's compliance with legal or regulatory requirements, the performance and independence of the company's outside auditor, and the performance of the internal audit function.

4. Each listed company must have an internal audit function.

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

Executive Sessions. NYSE Listed Company Manual §303A.03 requires that non-management directors schedule regular executive sessions in which they meet without management.

Website Requirement. Each listed company must have an accessible website, which provides the company's compensation, nominating and audit committee charters, and its corporate governance guidelines and code of business conduct and ethics. See NYSE Listed Company Manual §303A.14.

2. NASDAQ Stock Market

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

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

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

Independent Directors and Executive Sessions. NASDAQ Marketplace Rule 4350(c)(1)-(2) requires that a majority of the the board of directors must be comprised of independent directors as defined in rule 4200, and that the independent directors must have regularly scheduled meetings at which only independent directors are present.

Conflicts of Interest. NASDAQ Marketplace Rule 4350(h) requires that each company conduct a review of all related party transactions for potential conflicts of interest on an ongoing basis. All such transactions must be approved by the audit committee or another independent body of the board of

directors. See SEC Regulation S-K, Item 404 for the definition of the term "related party transaction."

Code of Conduct. NASDAQ Marketplace Rule 4350(n) requires that each listed company adopt a code of conduct applicable to all directors, officers and employees. The code must comply with the definition of a code of ethics set forth in Sarbanes-Oxley Act §406(c), and any SEC regulation.

3. American Stock Exchange

The American Stock Exchange maintains audit committee function and responsibility requirements. See American Stock Exchange Company Guide at §803.

V. OUTSIDE AUDITOR COMMUNICATIONS WITH THE AUDIT COMMITTEE

Various auditing pronouncements require the outside auditor to make certain inquiries of management, and of the audit committee members during the performance of a review or audit. Similarly, various accounting pronouncements also require the outside auditor to communicate specific information to management, and to the audit committee.

A. Statements on Auditing Standards

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

Pursuant to SAS 114, 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 at least 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, and material deficiencies or errors.

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.

Pursuant to SAS 114, the auditor should also communicate significant findings from the audit, such as 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.

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. 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.

Illegal Acts by Clients. The outside auditor should assure himself or herself that the audit committee, or others with equivalent authority and responsibility, is adequately informed about illegal acts that come to the auditor's attention. See Statement on Auditing Standards 54.

Additionally, §10A(a)-(f) of the Securities Exchange Act requires that the audit must include procedures designed to detect illegal acts; procedures designed to identify related party transactions; and an evaluation of whether there is substantial doubt about the ability of the issuer to continue as a going concern.

Consideration of Fraud in a Financial Statement. Statement on Auditing Standards 99 requires that the outside auditor ask management about knowledge or allegations of any fraud or suspected fraud affecting the company; 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; 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 auditor also should inquire directly of the audit committee (or at least its chair) regarding the audit committee's views about the risks of fraud and whether the audit committee has knowledge of any fraud or suspected fraud affecting the company. The auditor also should obtain an understanding of how the audit committee exercises oversight of the company's assessment of the risks of fraud and the programs and controls the company has established to mitigate those risks.

Interim Financial Information. In a review engagement, such as with respect to quarterly financial information, the outside auditor performs certain required procedures, which may cause the auditor to become aware of significant information regarding the financial statements. If the outside auditor does become aware of certain information during the course of a review engagement, Statement on Auditing Standards 100 requires the outside auditor to communicate that information to management and the audit committee as appropriate.

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

Understanding the Entity and its Environment. Statement on Auditing Standards 109 requires that the outside auditor 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 audit procedures. The provisions of SAS 109 apply for all audits, and are not limited to an evaluation of internal control under Sarbanes-Oxley §404.

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 company's control environment, 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.

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.

Communicating Internal Control Related Matters Identified in an Audit. Statement on Auditing Standards 112 applies for all audits, and its application is not limited to an evaluation of internal control under Sarbanes-Oxley §404.

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 function or risk assessment function for a company for which those functions are important to the monitoring or risk assessment component 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.

Financial Accounting Standards Board Statement of Financial Accounting Standards No. 5, Accounting for Contingencies, provides for three degrees of likelihood: probable, which means that the future event or events are likely to occur; reasonably possible, which means that the chance of the future event or events occurring is more than remote but less than likely; and remote, which means that the chance of the future event or events occurring is slight.

B. The Public Company Accounting Oversight Board, Auditing Standard No. 5

In 2007 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 Auditing Standard No. 2. Auditing Standard No. 5 applies to an audit of internal control, such as one performed under Sarbanes-Oxley §404, 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.

Auditing Standard No. 5 states 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:

-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.

It is beyond the scope of these materials to discuss Auditing Standard No. 5 in detail. The Standard is discussed in other materials written by the author.

C. The Independence Standards Board, Standard No. 1

Independence Standards Board Standard No. 1 requires that any auditor intending to be considered an independent accountant for purpose of the Securities Acts shall at least annually disclose to the audit committee of the company (or the board of directors if there is no audit committee), in writing, all relationships between the auditor and its related entities and the company and its related entities that in the auditor's professional judgment may reasonably be thought to bear on independence; confirm in the letter that, in its professional judgment, it is independent of the company within the meaning of the Securities Acts; and discuss the auditor's independence with the audit committee. Note: Standard No. 1 will be superseded by PCAOB Rule 3526 if approved by the SEC.

VI. DOCUMENTATION OF COMMITTEE MEETINGS AND ACTIVITIES

The audit committee should consider appropriately documenting committee meetings and actions for diligence and business judgment purposes, to aid with future actions and follow-up, to better avoid possible later confusion regarding actions taken and decisions made, and for the purpose of responding to potential outside auditor inquiries arising from Statement on Auditing Standards 109, 112 and 114, and Public Company Accounting Oversight Board Auditing Standard No. 5. The committee does need to consider which activities and discussions are sufficiently important to document. Although there should be reasonable concern that there could be an attempt by an outside entity to use the documentation as a road map to wrongdoing, a lack of documentation also could be viewed negatively, particularly if the standard of practice is to document activities. In a couple of high profile cases, courts have held that even investigation reports prepared through legal counsel can be discoverable in certain situations. Consideration also should be given to the U.S. Department of Justice so called McNulty Memorandum discussing federal prosecution of business organizations.

VII. INTERNAL INVESTIGATIONS AND REVIEWS

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, 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 this paper 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 recent 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.

VIII. THE AUDIT COMMITTEE CHARTER

The wording of the audit committee charter is significantly particular to each separate audit committee, board and company. Typical public company audit committee charters run three to six pages in length, depending on the degree of detail and the duties and responsibilities listed. At a minimum, for public companies the charter should cover the committee member qualifications and the committee functions and responsibilities required by securities statute, rule or regulation, and by the exchange on which the company's stock is listed. Although securities statute, rule and regulation requirements generally are the same for different public company audit committees, the specific NYSE and NASDAQ audit committee requirements are similar, but not identical. Thus, it is difficult to develop a generic charter,

and, in any event, the charter really should be drafted specifically for the particular company.

The charter is helpful and desirable not only to satisfy legal requirements, but also to clarify for all interested persons the composition, duties and responsibilities of the audit committee, and thus, at least indirectly, the duties and responsibilities that are not expected. At least one caveat should be kept in mind. In various cases courts have looked at the charter document to determine the audit committee's duties and responsibilities, and to hold the audit committee to those representations. Audit committee members and their counsel need to give appropriate consideration to the charter to ensure that it meets legal requirements, and that the committee members are certain that they understand and will undertake to satisfy the duties and responsibilities that are listed.

IX. INTERNAL AUDIT: ONE OF THE AUDIT COMMITTEE'S BEST RESOURCES

The Institute of Internal Auditors (http://www.theiia.org) states that "internal audit 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. Performed by professionals with an in-depth understanding of the business culture, systems, and processes, the internal audit activity provides assurance that internal controls in place are adequate to mitigate the risks, governance processes are effective and efficient, and organizational goals and objectives are met.

The internal audit activity evaluates risk exposures relating to the organization's governance, operations and information systems, in relation to:

-Effectiveness and efficiency of operations.

-Reliability and integrity of financial and operational information.

-Safeguarding of assets.

-Compliance with laws, regulations, and contracts.

Based on the results of the risk assessment, the internal auditors evaluate the adequacy and effectiveness of how risks are identified and managed in the above areas. They also assess other aspects such as ethics and values within the organization, performance management, communication of risk and control information within the organization in order to facilitate a good governance process.

The internal auditors are expected to provide recommendations for improvement in those areas where opportunities or deficiencies are identified. While management is responsible for internal controls, the internal audit activity provides assurance to management and the audit committee that internal controls are effective and working as intended. The internal audit activity is led by the chief audit executive ("CAE"). The CAE delineates the scope of activities, authority, and independence for internal auditing in a written charter that is approved by the audit committee."

The fact is that the audit committee significantly relies on other people to help it perform its duties. An

internal audit function can be one of the best resources available to help the audit committee perform its function. Pursuant to NYSE Listed Company Manual §303A.07, each listed company must have an internal audit function; however, it is not just NYSE listed companies that have or should consider having an internal audit function or department. Throughout this paper references are made to the audit committee's governace over and interactin with the internal audit function. Certainly the audit committee members of each public company should consider the value of having an internal audit function to assist the committee members in satisfying their functions and responsibilities.

The nature of the audit committee function is evolving. It is now standard that the person serving in the position of the chief audit executive functionally reports directly to the audit committee, and administratively, or by dotted line to the CEO, CFO or other compliance officer.

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

Commentary to §303A.07 states that the audit committee should evaluate the outside auditor's qualifications, performance and independence, and that in doing so the audit committee also should take into consideration the opinions of management and the company's internal auditors, and further provides in part that the audit committee may want to review with the auditor are the responsibilities, budget and staffing of the company's internal audit function.

Pursuant to SAS 112, an ineffective internal audit function or risk assessment function for a company for which those functions are important to the monitoring or risk assessment component of internal control should be regarded as at least a significant deficiency and a strong indicator of a material weakness in internal control.

PCAOB Auditing Standard No. 5 directs that the outside auditor should use a top-down approach to the audit of internal control over financial reporting, beginning at the financial statement level and company-level controls, and that company-level controls in part include controls to monitor other controls, including activities of the internal audit function, the audit committee, and self-assessment programs.

Internal audit has no direct operational responsibility or authority over any of the activites that it reviews. Internal audit does not develop or install systems or procedures, prepare records, or engage in any activity which would normally be audited. In that sense, internal audit is independent, although still an internal function of the company.

Internal audit carries out assigned responsibilities to examine and evaluate the adequacy and effectiveness of the organization's governance, risk managment processes (enterprise risk management is discused in other materials written by the author), system of internal control, monitoring processes,

and quality of performance to achieve the organization's stated goals and objectives. Internal audit also can act as an advisor and provide critical services that are integrated into the audit committee's activities and processes. Internal audit should have direct reporting authority and access to the audit committee and/or the committee's chair.

The chief audit executive usually submits to the audit committee and senior management a report of planned audit work, staffing, and a budget for the fiscal year, or more often. The audit work planned is developed using a priority, risk-based methodology. Internal audit should regularly report to the audit committee significant risk exposures and control issues, corporate governance issues, and other requested information.

Pursuant to the Institute of Internal Auditors, to establish an effective relationship between the audit committee and internal audit, the chief audit executive should,

-Communicate with the audit committee and management regularly on risks faced by the organization;

-Help the audit committee ensure that the committee's charter, activities and processes are appropriate;

-Ensure that internal audit's charter, role and activities are clearly understood and responsive to the needs of the audit committee and the board;

-Maintain open and effective communications with the audit committee and the committee's chair; and

-Provide training, when appropriate, to the members of the audit committee on topics of risk and internal control.

There needs to be a direct channel of communication between the chief audit executive and the audit committee. Typically the chief audit executive may attend portions of audit committee meetings to report on the results of major audits and key audit findings, and discuss internal audit's observations on risk and internal controls. The relationship can be strengthened by out-of-session communications between the chief audit executive and the audit committee chair and/or audit committee about critical circumstances or events. The chief audit executive and the audit committee should meet periodically without management or the outside auditor present.

The scope of internal audit may include:

-Reviewing the reliability and integrity of financial and operating information and the means used to identify, measure, classify, and report that information;

-Reviewing the systems established to ensure compliance with policies, plans, operations, and reports and whether the organization is in compliance;

-Reviewing the means of safeguarding assets and verifying the existence of assets;

-Reviewing operations and programs to ascertain whether results are consistent with objectives and goals, and whether operations and programs are being carried out as planned;

-Reviewing specific operations at the request of the audit committee or management as appropriate;

-Monitoring and evaluating the effectiveness of the organization's risk management and internal control systems;

-Reviewing the quality of the performance of the outside auditor and the degree of coordination between the outside auditor and internal audit; and

-Helping the audit committee to satisfy the committee' functions and responsibilities.

Following the conclusion of each audit assignment a report should be prepared and issued by the chief audit executive to the audit committee, and distributed as appropriate. As appropriate, the report may include management's responses and corrective actions to be taken in regarding to the specific findings and recommendations. If management's responses and corrective actions are not included in the report, as appropriate management should be provided time to provide written responses to internal audit, the audit committee, and other people on the distribution list. If the audit committee desires, internal audit should be responsible for appropriate follow up until the open issues are cleared.

Each member of the audit committee has unique experiences and knowledge. Thus, to a certain extent, internal audit can provide benefit and help to the individual audit committee members in similar, but also different individual ways. An audit committee member should be looking to internal audit for assistance in helping both the overall committee and the individual member satisfy the audit commitee's functions and responsibilities. By understanding the audit committee's functions and responsibilities, and the experiences, knowledge, strengths and weaknesses of the individual committee members, internal audit can best work to develop a plan of action that helps the audit committee to fulfill its functions and responsibilities, and help achieve the organizational objectives. Developing the plan of action is an interactive process involving the audit committee, internal audit, and management.

At the end of the day, in addition to satisfying his or her functions and responsibilities, an audit committee member should want to ensure that no significant, arguably avoidable, unfavorable ("bad") events occur for which it can be said that he or she might have had oversight responsibilities, and that if such an unfavorable event does unfortunately occur, he or she can establish that it occured despite his or her verifyable, diligent, best practice efforts and activities as an audit committee member. Internal audit can be instrumental in helping the audit committee members achieve that level of comfort.

X. ANNUAL AUDIT COMMITTEE EVALUATION

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

Prudent audit committee make-up and conduct are important to reduce both audit committee and overall company liability and damages risk. At the audit committee level, cases hold that the audit committee members can be held liable for the failure to exercise sufficient diligence, and for the failure

to spot and respond to red flags. See, e.g., *In re Hollinger International, Inc. Securities Litigation* (N.D. Ill. 2006) 2006 U.S. Dist. Lexis 47173; *In re WorldCom, Inc. Securities Litigation* (S.D. N.Y. 2005) 2005 U.S. Dist. Lexis 4194; and *In re Hayes Lemmerz International, Inc. Equity Securities Litigation (E.D. Mich. 2003) 271 F. Supp. 2d 1007*. Additionally, active board and corporate diligence tend to negate allegations of intent to commit wrongdoing, thus reducing the risk of securities liability and damages. See, e.g., *In re Digi International, Inc. Securities Litigation* (8th Cir. 2001) Fed. Appx. 714.

Cases alleging audit committee and board member liability often arise in the context of alleged improper accounting practices, written and oral public misrepresentations (such as with respect to financial matters), and improper employment practices. The audit committee is directly responsible for board level oversight of the company's accounting practices, and disclosures in the company's quarterly and annual financial statements. To a certain extent the audit committee may be responsible for board level oversight of financially related press releases and other disclosures of financial information if the committee's Charter so provides. New York Stock Exchange List Company Manual §303A.07 also requires audit committees of listed companies to discuss the company's earning press releases, as well as financial information and earnings guidance provided to analysts and rating agencies. And, at least Statement on Auditing Standards 109 requires the outside auditor to inquire into matters pertaining to the five areas of internal control for the purpose of risk assessment—one of the five areas of inquiry, the "control environment" area, includes inquiry into the company's processes relating to human resource policies and practices. Thus, prudent audit committee make-up and conduct can be important to reduce liability and damages risk not only at the audit committee level, but also for management and the entire board.

Serving as an audit committee member requires broad, current subject matter technical knowledge and interest, diligence, leadership and oversight, organization, prudent judgment, inquisitiveness, an appropriate level of skepticism, and effective communication skills. Audit committee work is year round. Issues and deadlines can be demanding. At various levels the members interact not only as a committee, but also with the board, CEO, CFO, outside auditor, legal counsel, tax professionals, internal audit if such exists, and other professionals. Other people also rely on the audit committee's effectiveness. Thus, it only makes sense that the committee should at least once each year take time to step back and review, evaluate and make improvements to its manner of operation, and also consider actions that can be made by other people with whom the committee interacts to improve audit committee effectiveness and ease of operation. Annual self-evaluation is worthwhile if it only results in improved communications, or one improvement in an area that has the potential for significant risk exposure.

No specific evaluation process or format is required. One possible approach to evaluation is outlined below.

Although not required, there can be advantages to having a facilitator conduct an interactive evaluation approach without performance grading or rating: it can be difficult to construct a questionnaire with standardized questions that would be similarly understood by each of the participants; different people use different grading or rating scales; different people express responses in different manners; and certain important issues will change from year to year. A facilitated approach may allow for better discussion and comment, continuity, follow-up, explanation and compilation.

Also consider whether the evaluation will be conducted under the umbrella of legal counsel. I mention this potential issue; however, I do not consider it to be of seminal importance. The fact is that board and committee members should always consider that their activities may be discoverable, and that they may want to voluntarily make their activities known so as to demonstrate diligent business judgment, or to negate allegations improper intent, recklessness, or intentional wrongdoing, also known as "scienter" in the context of securities litigation.

Issues and topic areas for evaluation will naturally vary somewhat from entity to entity, and from audit committee to audit committee. Thus, I have listed below the evaluation and outline of issues and topic areas as one of the first steps in the evaluation process. Staying within the scope of the audit committee's Charter and responsibilities, the committee should also consider reviewing or evaluating performance in areas of significant possible risk exposure to the company. To help get your thought process going, the following is an overview of a sample evaluation process, and a list of select possible broad issues and topic areas that may be covered. Consider both successes and possible improvements.

1. Overview of the Evaluation Process:

    -Evaluate and prepare an outline of issues or topic areas (broad and specific) for review and consideration by the participants, allowing for participant comments about additional or discretionary issues or topics that are not on the outline.

    -Develop a list of the people participating in the process, including not only the audit committee members, but also possible other people who may be contacted for comment.

    -Timely disseminate the outline of issues or topics.

    -Determine how interviews will be performed; and conduct private one-on-one interviews with individual participants to obtain feedback and suggestions.

    -Appropriately compile/summarize interview comments and suggestions.

    -Report comments and suggestions to audit committee members, and possibly conduct a committee group review of the process, comments, suggestions and follow-up or next steps.

2. Sample List of Select Possible Issues or Topics to Consider for Evaluation:

    -The committee meeting agenda preparation and dissemination process.

    -Issues pertaining to committee member independence qualification.

    -Issues pertaining to committee member financial literacy or expertise qualifications.

    -Committee member knowledge and access to information and education. Are the needs of the committee members being met, so that they are sufficiently knowledgeable about the company and its industry; relevant significant accounting and auditing topics; legal matters including standard of care; internal controls and risk management; governance; and new developments in

those and other areas?

-Committee and committee member interaction, including interaction between committee members, and interaction and relationships between the committee and other people including the board, senior officers, the independent auditor, the internal auditor, legal counsel, and consultants.

-The process of issue spotting, evaluation and decision making process.

-The contents of the audit committee Charter, and a mutual understanding of the audit committee's activities.

-Review of the performance of the outside auditor, and of the quarterly review and annual audit process.

-Internal controls.

-Current accounting principles, policies or issues that are significant to the company.

-Review of the company's financial and the internal audit positions and functions.

-Review of processes pertaining to compliance with significant laws and regulations that are within the scope of the audit committee's functions and responsibilities.

-Documenting and reporting committee activities; minutes.

-Audit committee use of attorneys and consultants.

3. Sample List of Possible Additional Issues or Topics for Evaluation:

-The company's investor communication processes.

-The processes for identifying and evaluating risk management and possible liability exposure situations that are within the scope of the audit committee's function.

-Whistleblower, ethics and complaint handling processes; corporate investigations; and compliance with laws, rules and regulations, including employer, employee and workplace processes.

-Governance, including tone at the top.

-Insurance.

-All additional significant topics or issues that should be discussed, or about which the evaluation facilitator should be made aware for purpose of the evaluation process.

XI. AUDIT COMMITTEE MEETING AGENDA TOPICS

The following is a list of possible audit committee meeting agenda topics. Of course, actual agenda topics will vary from entity to entity, and also will depend on the facts and circumstances pertinent to the particular meeting. The list does not include every possible agenda topic. It is also not intended to suggest that an audit committee should address each topic that is listed. The list is intended as a helpful tool to prompt consideration of possible agenda topics.

1. Overview of general considerations:

-Review of the audit committee charter and committee responsibilities.

-Review of audit committee member qualifications, changes and disclosures.

-Use of legal counsel and consultants.

-Review of pre-meeting and meeting processes; preparation and dissemination of agenda and meeting materials.

-Consideration of executive session, and of potential non-committee members to consult with prior to or to be present part of the time at the meeting, including the CEO, the CEO, the chief internal auditor, the outside auditor, in-house counsel, the company's compliance officer, outside counsel retained by the audit committee, other outside consultants, and other people from management.

-Review of the business judgment rule, reliance on other people, decision making process, and pertinent securities laws and developments; issue spotting; relevant inquiries; investigation as necessary; input and advice; evaluation; need for additional information; and follow-up.

-Consideration of audit committee annual performance evaluation process.

-Documenting and reporting committee activities; minutes; reporting to and interacting with the board.

-Document retention policies and practices.

-Understanding informaton provided by audit, review and compilation opinions or reports.

2. Overview of possible meeting specific topics of consideration:

-Judgment about the quality, not just acceptability, of the company's accounting and transaction principles, methods, timing and estimates.

-Clarity, consistency and completeness of company financial statement accounting information.

-Financial statement impact of certain items such as timing of transactions, period cutoff

procedures, accounting policy selection, estimates, contingencies, reserves, revenue recognition, inventories, goodwill, judgments, uncertainties and unusual transactions.

-Outside auditor's responsibilities under Generally Accepted Auditing Standards (GAAS), including scope of services.

-Critical accounting polices, principles and practices used and consistently applied, and related changes including any change to a possibly less appropriate accounting principle; consider alternative acceptable practices discussed and not discussed with management, and the treatment preferred by the outside auditor.

-Difficulties encountered during the review or audit. Were there any limitations?

-Consultations with other accountants by management or outside auditor.

-Analytic and other evaluation of financial statements.

-Material communications between outside auditor and management, including the management letter.

-Material communications between outside auditor and internal auditor function.

-Disagreements between management and outside auditor.

-Any other significant matters that came to outside auditor's attention, including improvements recommended by auditor.

-Internal control design, implementation, operation, changes, assessment, deficiencies or weaknesses, and corrections.

-Off-balance sheet transactions, arrangements, obligations (including contingent) and other company relationships.

-Possible material misstatement due to departure from Generally Accepted Accounting Principals (GAAP).

-Testing for fraudulent or unlawful acts or activities.

-Critical matters identified during the review or audit.

-Significant review or audit adjustments and unadjusted differences, including differences that were determined by management to be immaterial individually and in the aggregate to the financial statements taken as a whole.

-Outside auditor's comments about internal audit, accounting and CFO functions.

-Are financial statements free of material misstatements?

-Consideration of MD&A; financial information releases; and investor communication processes and information provided.

-Completion of officer certification, and internal and disclosure control requirements and processes.

-Possible insider and related party transactions, and conflicts of interest.

-Discussions with outside auditor pursuant to SAS 114 (auditor's communications with those charged with governance); SAS 54 (unlawful activities); SAS 99 (fraud); SAS 109 (understanding the entity and its enviroment); SAS 100 (interim financial statements); and SAS 112 (internal control).

-Other information included in the financial statements and documents containing the financial statements, including footnotes, and presentation of pro forma financial information.

-Recommendation that the board approve the auditor's opinion or report, and the financial statements; presentation to the board.

3. Outside auditor services:

-Outside auditor retention and compensation.

-Outside auditor independence and related disclosure of information; partner/manager rotation.

-Services to be performed: audit, review or compilation services; possible tax services; possible additional non-audit services; approval of services.

-Timing and planning for services to be provided.

4. Overview of other topics of considerations, on more of an ongoing basis:

-Follow-up items, new matters, and other.

-The operations, activities and functioning of internal audit; specific reports from internal audit regarding its activities.

-Issues specific to the company; specific to the industry.

-Ethics, legal and whistleblower reporting protections and processes; complaints and corporate investigations. Confidential and anonymous submission, and procedures for receipt, retention, and treatment of complaints regarding accounting, internal controls, and auditing matters, and possible unlawful acts.

-Anti-retaliation polices and practices.

-Tone at the top and communication of tone at the top; governance; code of ethics; and workplace policies and practices.

-Risk management or ERM, and possible liability or legal exposure issues for which the audit committee has responsibility.

-Audit committee D&O insurance coverage.

XII. THE FOREIGN CORRUPT PRACTICES ACT

The Foreign Corrupt Practices Act (15 U.S.C. §§ 78dd-1, et seq.) is a U.S. federal law that is comprised of two primary provisions: (1) the accounting record keeping and internal control provision, and (2) the antibribery provision.

The accounting record keeping and internal control provision (15 U.S.C. § 78m) was intended to compliment or work in tandem with the antibribery provision, but in fact is perhaps more broad in application because it applies to all companies whose securities are listed on a U.S. stock exchange, and is enforced by the Securities and Exchange Commission. Generally, the accounting provision was intended to require covered companies to keep accounting records that accurately reflect the transactions of the company, and to devise and maintain an adequate system of internal accounting control. The accounting provision is intended to address three areas of concern: (1) situations where transactions are not recorded; (2) situations where transactions are falsely recorded; and (3) situations where transactions are recorded correctly but are also misrepresented in substance (e.g., where a payment is correctly recorded is being made to the appropriate person but with substantial certainty that person then will transfer the payment to another person for an unlawful purpose.

The FCPA does not mandate the specific elements or form of internal control system. The Act requires reasonable detail and assurances. "Materiality" is not a minimum threshold safe harbor, not is lack of knowledge or substantial certainty.

The accounting and internal control provision requires covered companies to:

-Keep books, records and accounts that, in reasonable detail, accurately and fairly reflect the company's transactions; and

-Devise and maintain a system of internal control sufficient to provide reasonable assurance that:

-Transactions are authorized by management;

-Transactions are recorded to permit preparation of financial statements in conformity with Generally Accepted Accounting Principles and other applicable standards, and to maintain accountability over assets;

-Access to assets is permitted only with management authorization; and

-Recorded accountability for assets is periodically reconciled with existing assets.

The Act also requires that a covered company that holds sufficient voting power over another company, including a foreign corporation, comply with the Act's provisions with respect to the other company. Sufficient voting power is present when a covered company controls 50 percent or more of the voting securities of a subsidiary. However, depending on the facts and circumstances, sufficient voting power also can be present when a covered company controls between 20 and 50 percent of a subsidiary– subject to contrary proof by the covered company that its ownership does not constitute control.

Generally, the antibribery provision makes it unlawful for (1) U.S. firms and persons, and certain foreign issuers of securities, to make a corrupt payment (e.g., a bribe) to a foreign official for the purpose of obtaining or retaining business, and (2) foreign firms and persons to act in furtherance of a corrupt payment while in the United States.

The Department of Justice is responsible for criminal and civil enforcement with respect to domestic concerns, foreign companies and nationals. The SEC is responsible for civil enforcement of the antibribery provisions with respect to issuers.

Establishing a violation of the antibribery provision involves five basic elements.

To whom the Act applies. The Act applies to any individual, firm, officer, director, employee, or agent of a firm and any stockholder acting on behalf of a firm. Individuals and firms may also be penalized if they order, authorize, or assist someone else to violate the antibribery provisions, or if they conspire to violate those provisions.

United States jurisdiction over improper payments to foreign officials depends on whether the violator is an "issuer," a "domestic concern," or a foreign national or business.

An "issuer" is a corporation that has issued securities that have been registered on a U.S. exchange, or that is required to file periodic reports with the SEC.

A "domestic concern" is any person who is a citizen, national, or resident of the United States, or any corporation, partnership, association, joint-stock company, business trust, unincorporated organization, or sole proprietorship which has its principal place of business in the United States, or which is organized under the laws of a State, territory, possession or commonwealth of the United States.

For acts that occur within the territory of the United States, issuers and domestic concerns are liable if they perform an act in furtherance of a corrupt payment to a foreign official using the U.S. mails or other means of interstate commerce, including, for example, telephone calls, faxes, wire transfers, and interstate or international travel.

Issuers and domestic concerns may also be liable for acts performed in furtherance of a corrupt payment made outside the United States. Thus, a U.S. company or national may be held liable for a payment

authorized by employees or agents operating outside the United States, using money from foreign bank accounts, and without any involvement by a person located in the United States.

The FCPA was expanded in 1998 to include jurisdiction over foreign companies and people who cause, directly or through agents, an act in furtherance of the corrupt payment to take place in the territory of the United States, whether or not the act makes use of the U.S. mails for other means of interstate commerce.

U.S. parent companies also may be held liable for the acts of foreign subsidiaries, the activities of which they authorize, direct, or control, as can U.S. citizens or residents ("domestic concerns) who were employed by or acting on behalf of the foreign subsidiary.

Wrongful intent or purpose. The person making or authorizing the payment, offer, promise or inducement must have a wrongful or corrupt intent or purpose, and the payment must be intended to induce or influence the foreign official who is receiving the payment to misuse his or her official position, to breach his or her lawful duty, to make a decision, or to otherwise act to direct business wrongfully to the payer or to any other person, or to obtain any improper advantage, or to induce the foreign official to use his or her influence improperly to affect or influence any act, event or decision. However, the intended corrupt act does not have to actually succeed in purpose for a violation to occur. Thus, an offer or promise alone can be a violation.

Payment. The Act prohibits paying, offering, promising to pay (or authorizing to pay or offer) money, or anything of value.

The Act also prohibits corrupt payments made through an “intermediary,” also referred to as third party payments. The “intermediary” is the recipient who is making the payment to the foreign official. It is unlawful to make a payment to a third party, while “knowing” that all or a portion of the payment will go directly or indirectly to a foreign official. The term "knowing" includes conscious disregard and deliberate ignorance. In other words, it is not necessary to show actual knowledge for there to be a violation. Thus, U.S. companies should exercise due diligence, investigate other entities and persons with whom they interact, react to and investigate “red flags,” and establish proper and prudent compliance staffing, procedures and processes. See also the overview of the FCPA accounting record keeping and internal control provision.

The recipient. The Act applies only with respect to corrupt payments to a foreign official, a foreign political party or party official, or any candidate for foreign political office.

A "foreign official" means any officer or employee of a foreign government, a public international organization, or any department or agency thereof, or any person acting in an official capacity, regardless of rank or position. The Act focuses on the purpose of the payment, not the duties of the recipient (see however, the “facilitating” payment exception discussed below). Whether or not a person is a “foreign official” can be difficult to determine. Consider, for example, royal family members, an official of a state-owned business, or members of a legislative body.

The business purpose test. The Act prohibits payments made in order to assist the firm in obtaining or retaining business for or with, or directing business to, any person. You should be aware that the term

"obtaining or retaining business" is broadly interpreted for enforcement purposes. Additionally, the business to be obtained or retained does not need to be with a foreign government or foreign government instrumentality.

The exception for facilitation payments for routine governmental actions. The Act provides that there is no violation of the antibribery provision for payments made to facilitate or expedite performance of a "routine governmental action." The Act lists the following examples: obtaining permits, licenses, or other official documents; processing governmental papers, such as visas and work orders; providing police protection, mail pick-up and delivery; providing phone service, power and water supply, loading and unloading cargo, or protecting perishable products; and scheduling inspections associated with contract performance or transit of goods across country. Other similar actions might also be excluded. However, the "routine governmental action" exclusion does not include or apply to any decision made by a foreign official to award new business or to continue business with a particular party.

Possible affirmative defenses available to a person charged with a violation:

In addition to being able to prevail on one or more of the five basic elements discussed above, there are a couple of affirmative defenses that an accused defendant may be able to argue and establish for the payment or action:

> -The payment was lawful under the written laws of the foreign country. Obviously, prior to making a potentially improper payment you should seek the advice of counsel regarding the "legality" of the payment under the laws of the foreign country; and
>
> -The money was spent as part of demonstrating a product or performing a contractual obligation.

Criminal sanctions, penalties and jail time. Criminal punishment for violation of the FCPA antibribery provisions are as follows: corporations and other business entities may be fined up to $2,000,000; and officers, directors, stockholders, employees, and agents may be fined up to $100,000 and imprisonment for up to five years. Additionally, under the Alternative Fines Act the fine may increased up to twice the benefit that the defendant sought to obtain by making the corrupt payment. Fines imposed on individuals cannot be paid by the individual's employer or principal.

Civil fines and injunctive remedies:

The Attorney General or the SEC may bring a civil action seeking a fine up to $10,000 against any firm, officer, director, employee, or agent of a firm, or any stockholder acting on behalf of the firm, for violation of the antibribery provisions. Additionally, in an action brought by the SEC, the court may impose an additional fine not to exceed the greater of the gross amount of the monetary gain to the defendant as a result of the violation, or a specified dollar limitation based on the egregiousness of the violation, ranging from $5,000 to $100,000 for a natural person and $50,000 to $500,000 for any other person.

The Attorney General or the SEC may also bring a civil action to enjoin (i.e., stop or prevent) any act or practice of a firm whenever it appears that the firm, or an officer, director, employee, agent, or

stockholder acting on behalf of the firm, is in violation, or about to be, in violation of the antibribery provisions.

Private cause of action. A private cause of action may also be brought against the wrongful firm or person, such as by an aggrieved business competitor, for treble damages under the Racketeer Influenced and Corrupt Organizations Act (RICO), and under various other federal or state laws.

Additional possible penalties and sanctions:

A person or firm found in violation of the FCPA may be barred from doing business with the Federal government. An indictment can lead to the suspension of the right to do business with the government.

A person or firm that is guilty of violating the FCPA can be held ineligible to receive export licenses.

The SEC may suspend or bar a person or firm from the securities business and impose civil penalties on firms or persons in the securities business for violation of the FCPA.

The Commodity Futures Trading Commission and the Overseas Private Investment Corporation may suspension or debarment a person or firm from agency programs for violation of the FCPA.

And, a payment made to a foreign government official that is unlawful under the FCPA cannot be deducted for tax purposes.

XIII. FEDERAL SENTENCING GUIDELINES, ORGANIZATIONAL COMPLIANCE

Organizations, such as corporations, can be guilty of criminal conduct, just like individuals. The measure of an organization's punishment for felonies and certain misdemeanors is governed by Chapter Eight of the U.S. Federal Sentencing Guidelines. Organizations cannot be imprisoned, but they can be fined, sentenced to probation, ordered to make restitution and issue public notices of conviction, and exposed to forfeiture statutes.

Some of the common offenses committee by organizations are fraud, environmental waste, tax offenses, antitrust offenses, and food and drug violations.

An organization can be found criminally liable whenever an employee of the organization commits an act within the apparent scope of his or her employment, even if the employee acted contrary to company policy or instructions. An organization also can be held criminally liable for any of its employees' illegal actions even if it made reasonable efforts to prevent the wrongdoing. Recognizing this fact, in enacting the sentencing guidelines, the U.S. Sentencing Commission has attempted to lessen some of the harshest aspects of potential liability for organizations that can demonstrate that they have enacted appropriate and effective preventative, deterrent and reporting compliance programs.

The Federal Sentencing Guideline Manual at Chapter 8, Part B, §8B2.1, Effective Compliance and Ethics Program, specifies that to have an effective compliance and ethics program, an organization shall:

-Exercise due diligence to prevent and detect criminal conduct; and

-Promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law.

Compliance and ethics programs should be designed, implemented, and enforced so that they are generally effective in preventing and detecting criminal conduct.

Due diligence and the promotion of an organizational culture that encourages ethical conduct and a commitment to compliance with the law minimally require that:

-The organization establishes standards and procedures to prevent and detect criminal conduct.

-The organization effectively communicates and promotes its standards, expected manner of conduct, procedures and other aspects of its compliance and ethics program throughout the organization including, but not necessarily limited to, all levels of employees, officers, managers, supervisors and directors.

-The organization's governing authority is knowledgeable about the content and operation of the compliance and ethics program and exercises reasonable oversight with respect to the implementation and effectiveness of the program.

-High-level personnel of the organization ensure that the organization has an effective compliance and ethics program, and are assigned overall responsibility for the program.

-Within the organization a specific person is, or specific people are, delegated day-to day operational responsibility for the compliance and ethics program, with adequate resources, appropriate authority and direct access to the governing authority, and shall report periodically to high-level personnel and, as appropriate, to the governing authority, or an appropriate subgroup of the governing authority, on the effectiveness of the compliance and ethics program.

-The organization takes reasonable steps:

-To ensure that the compliance and ethics program is followed, including monitoring and auditing to detect criminal conduct;

-To evaluate periodically the effectiveness of the compliance and ethics program; and

-To have and publicize a system, which may include mechanisms that allow for anonymity and confidentiality, whereby the organization's employees and agents may report or seek guidance regarding potential or actual criminal conduct without fear of retaliation.

-The organization's compliance and ethics program is promoted and enforced consistently throughout the organization through (A) appropriate incentives to perform in accordance with the compliance and ethics program; and (B) appropriate disciplinary measures for engaging in

criminal conduct and for failing to take reasonable steps to prevent or detect criminal conduct.

-After criminal conduct has been detected, the organization takes reasonable steps to respond appropriately to the criminal conduct and to prevent further similar criminal conduct, including making any necessary modifications to the organization's compliance and ethics program.

-In implementing the program, the organization periodically assesses the risk of criminal conduct and takes appropriate steps to design, implement, or modify each requirement to reduce the risk of criminal conduct identified through the process.

The term "governing authority" means the (1) the board of directors; or (2) if the organization does not have a board of directors, the highest-level governing body of the organization.

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 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). Whether an individual falls within this category is determined on a case-by-case basis.

XIV. D&O INSURANCE

The following is a detailed overview of common D&O insurance issues and provisions. Be sure to consult with your broker and/or legal counsel for your particular circumstances.

Standard D&O Insurance Covers:

• Liabilities owed by the individual directors and officers, including attorneys' fees (sometimes referred to as Side A liability coverage); and

• Amounts paid by the company as indemnification when the company is able to indemnify the directors and officers for liability arising from alleged wrongful acts (sometimes referred to as Side B indemnity coverage). Some policies also provide coverage (sometimes referred to as Side C entity coverage) for certain claims made directly against the company. There is tremendous variation in insurance policy coverage, so each should be structured to address the specific needs of the company for which it is written.

Losses Covered

Losses typically covered under D&O insurance include amounts that the directors or officers are legally obligated to pay for claims against them for wrongful acts, including settlements, judgments, costs of litigation and investigation, attorneys' fees and other related items. The definition of the losses covered under the company reimbursement provision typically includes amounts that the company is permitted to pay to indemnify the directors and officers. From the insurance policy's viewpoint, a company's indemnity payments are a loss: they are payments that the company has to make to directors or officers to pay for liability that they incur as a result of their wrongful acts. Policies are self-liquidating, meaning that the amounts paid, such as for attorneys' fees, reduce the amount remaining for future coverage.

Generally, coverage won't include fraud, willful or intentional wrongdoing, and criminal or highly culpable misconduct. Whether or not an act is willful or highly culpable may be the subject of disagreement, but an option may be available that makes coverage contingent upon some final judgment of wrongdoing. Losses relating to punitive damages also generally are not covered. And depending on circumstances, fines, penalties and treble damage amounts may or may not be covered.

D&O Coverage Exclusions and Other Limitations

The following are typical possible exclusions. That said, if there is an exclusion, it may be possible to purchase an endorsement to the policy, or a separate policy, to cover the excluded area. For example, it would be possible to add an endorsement/separate policy to cover employment practices liability, or ERISA, or bodily injury and property damage.

• Other or prior insurance. Coverage is typically excluded if the company's payment for loss or indemnity is covered by other or prior insurance.

• Bodily injury or property damage.

• Losses relating to pollution or contamination.

• ERISA.

• Libel and slander claims.

• Personal gain. Claims relating to personal profit or advantage to which the insured was not legally entitled.

• Unauthorized remuneration. Claims seeking restitution of amounts paid to directors or officers without prior shareholder approval, or that a court has held to be unlawful.

• Securities Exchange Act Sec. 16(b) Short Swing Profits. D&Os are liable to pay back profits that they obtain by buying and selling, or selling and buying stock of the company in which they are a D&O if they hold that stock for a period of less than six months. These are referred to as short swing profits.

The law is intended to prevent directors and officers to benefit from the unfair use of information that they receive.

• Breach of contract.

• Insured v. Insured. Claims brought by the company against directors and officers or former directors and officers, such as with respect to shareholder derivative suits or representative class action suits.

• Regulatory exclusion. Suits brought by federal or state regulatory agencies, or on behalf of an agency by a third party.

• Activities relating to mergers and acquisitions, golden parachutes, etc.

• Public offerings of securities.

• Prior acts. Policies are written on a claims-made basis, which means a claim—an allegation of liability by a plaintiff—must be made during the policy period. However, when a company has had a difficult history, such as a prior policy cancellation or non-renewal, a lapse in coverage or a serious financial crisis, there may be an exclusion for prior acts. Thus, the policy would cover only claims made for acts that occurred after the policy period began.

• Pending or prior litigation.

• Questionable payments. This includes items such as commissions, favors, or gifts paid to government officials, agents, employees, representatives and other related people.

• Discrimination. However, some D&O policies have added employment practices liability coverage. Alternatively, there may be an option to purchase a separate EPLI policy.

• Antitrust litigation.

• Failure to maintain insurance.

• Anti-concurrent clause. A clause stating that if multiple events or things cause damage, and if at least one of those events or things is not covered by the policy, then coverage may be denied for all events and things under the policy.

The following are some additional D&O application policy issues to consider:

• Concealment or misrepresentation. The application for D&O insurance requires the company to provide information regarding its history, operations, stock ownership, directors and officers, other insurance, certain transactions and acts or omissions that might provide grounds for future claims. The application for insurance is typically signed by an officer, to the best of that officer's knowledge and belief.

Pursuant to California Insurance Code Sec. 331, intentional or unintentional concealment entitles the

insurer to rescind the policy. Fraudulent misrepresentation also allows coverage denial or policy rescission. One option may be to include language stating that fraud or inaccuracies in the application are not imputed to innocent directors and officers who were unaware of the untrue or incorrect information provided. Another option may be for the policy to provide for nonrescindable coverage.

• Retention amounts. The insurer's duty to make payments may arise only after those insured have incurred a loss that exceeds a set amount, referred to as a "retention," which is in essence a deductible. The individual director or officer will want to avoid a retention provision or have the amount be as low as possible. A multiple retention issue can arise when multiple claims arguably relate to the same wrongful act. One option may be for the policy to state that a single retention will apply to claims alleging or relating to related wrongful acts.

• Co-insurance. The policy may contain a co-insurance clause, requiring those insured to pay a share of the overall liability above the retention amount. Directors and officers will want to avoid a co-insurance clause, especially with respect to Side A coverage.

• Severability of conduct exclusion. Wrongful conduct of one director or officer may impact the coverage for other innocent directors or officers. Language should be included stating that wrongful conduct by any director or officer will not be imputed to the other directors or officers.

• Bankruptcy. In bankruptcy a lawsuit may be brought by a trustee or by creditors, arguably on behalf of the company. Thus, the lawsuit could be characterized as being insured v. insured, for which coverage might be denied. An option may be for the policy to exclude coverage only for claims brought by the company, not on behalf of the company. It has also been argued in bankruptcy that the D&O policy or proceeds may be an asset of the company, thus complicating any payment under the policy. An option may be for the policy to give priority to payments made to protect the directors and officers over payments made to protect the company.

• Timing of defense cost payments. Policies vary regarding the timing of the insurer's payment of defense costs. For example, the insurer may want to make payments semi-annually, annually or prior to final disposition. Those insured and their attorneys will want the policy to require insurer payment or reimbursement within a specific number of days.

• Duty to defend. D&O lawsuits typically involve multiple defendants and multiple claims. The policy may provide coverage for some, but not all of the defendants and claims. Issues also may exist regarding which defendants and claims are covered. Some policies attempt to address these issues with language containing preset terms, or stating that payment is not required until the issues have been resolved by agreement.

Preset policy provisions usually are not favorable to those insured and a silent policy may be preferable. Generally there is a duty to defend an insured or potentially insured against covered and potentially covered claims, although the insurer may reserve its right of reimbursement. Additionally, even if indemnity is prohibited, there may still remain an insurer duty to defend.

• Amount of coverage and the shared limits. As a result of increasing settlement and judgment amounts, and increasing coverage being offered for entity liability and new areas such as employment practices,

less coverage may be available to protect the individual directors and officers. Options that may be available include purchasing increased policy limits, policy wording that gives preference to payments made for the protection of the directors and officers, or wording that allocates certain policy limits exclusively for the protection of the directors and officers.

• Separating coverage for the directors and officers. Director and officer liability coverage (Side A coverage), although separate from the indemnity and entity coverage provisions in the same policy, may still be impacted by application concealment or misrepresentation, company bankruptcy, wrongful conduct by other people and liquidating policy limits. Various options may be available for the directors and officers, including the outside directors, through the purchase of a separate policy covering just those directors or officers, or an excess umbrella policy.

• Choice of law, jurisdiction, forum and alternative dispute resolution provisions. Directors and officers should have their broker or attorney review policy provisions relating to choice of law, where and how coverage disputes must be adjudicated, and dispute resolution requirements which may be disadvantageous to the insured.

As an example, an insurer that is headquartered in Philadelphia may want a policy that covers an insured that is located in California to state that all disputes will be resolved in Philadelphia under Pennsylvania law. Philadelphia as a location would be more difficult for the insured, and Pennsylvania law might be less advantageous to the insured than the insurance laws in California.

Some Additional Concerns

Directors and officers must strategically structure their policies. Insureds may want to consider carrier financial rating, claim paying experience, and policy limits. There has been a rise in the average dollar amount paid in class action settlements. Additionally, we are seeing remaining available policy limits being further reduced by escalating defense costs and claims being made that are different than historically typical securities claims, such as derivative lawsuits; stock option, subprime, and opt-out claims; and regulatory and criminal proceedings.

International issues have also become important. A D&O insurance program should take into account foreign jurisdictional requirements where a U.S. company has major operations.

Looking Ahead

While many directors and officers are increasingly focusing on enterprise risk management, they should also focus attention to their own liability exposure and their D&O insurance coverage, understanding that it is not uncommon for D&O insurance coverage to benefit the company, insiders and outside directors differently.

Generally, people involved with D&O insurance will want to evaluate their situation (the industry, products, services and risk exposures of the company and its directors and officers to lawsuit and liability—including the dollar amount of coverage that should be purchased) and need for insurance coverage. It would also be wise for an insured director or officer (as well as the company) to ask about each area of possible exclusion or limitation to see if the policy covers the company, directors and

officers for those items. If the policy does not, some manner of coverage could or should be arranged either by an additional endorsement to the policy or by purchasing a separate policy to cover those areas in which it is determined that insurance can and should be purchased.

Lawsuits are filed against directors and officers for different and sometimes surprising reasons. But they all tend to involve large dollar liability risk and are expensive to defend. While D&O insurance is an important type of insurance that every public, private and nonprofit entity must consider, policies are not standardized and are generally written to address the specific—and sometimes conflicting—needs of the insured entity and D&Os, so it's important that directors and officers fully understand the policy they are working under to ensure proper coverage.

XV. ENTERPRISE RISK MANAGEMENT

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) defines enterprise risk management as "a process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.

The definition reflects certain fundamental concepts. Enterprise risk management is:

-A process, ongoing and flowing through an entity;

-Effected by people at every level of an organization;

-Applied in strategy setting;

-Applied across the enterprise, at every level and unit, and includes taking an entity level portfolio view of risk;

-Designed to identify potential events that, if they occur, will affect the entity and to manage risk within its risk appetite;

-Able to provide reasonable assurance to an entity's management and board of directors; and

-Geared to achievement of objectives in one or more separate but overlapping categories." See also, http://www.coso.org.

Enterprise risk management focuses on the achievement of objectives established by the business entity such as performance and profitability targets--to help the business get to where it wants to go--and avoid loss of resources, pitfalls and surprises along the way. Internal control is a component of enterprise risk management.

Various authorities require that the audit committee oversee financial internal controls, the outside auditor, and internal audit. Although no authority expressly requires the audit committee to exercise

oversight over enterprise risk management as that term is broadly defined by COSO, in pertinent part, NYSE Listed Company Manual §303A.07 requires the audit committee's Charter to addresses the committee's duties and responsibilities including the responsibility to discuss policies with respect to risk assessment and risk management. Commentary to §303A.07 states that the CEO and senior management should assess and manage the company's exposure to risk, but that the audit committee must discuss guidelines and policies to govern the process by which this is done. The audit committee should discuss the company's major financial risk exposures and the steps management has taken to monitor and control exposures. If a company manages and assesses its risk through mechanisms other than the audit committee, the processes that the company has in place should be reviewed in a general manner by the audit committee, but those mechanisms need not be replaced by the audit committee. Additionally, some, perhaps many, audit committees have included various elements of risk management oversight responsibilities in their Charters.

COSO further details enterprise risk management as:

1. Enterprise risk management encompasses:

-*Aligning risk appetite and strategy* – Management considers the entity's risk appetite in evaluating strategic alternatives, setting related objectives, and developing mechanisms to manage related risks.

-*Enhancing risk response decisions* – Enterprise risk management provides the rigor to identify and select among alternative risk responses – risk avoidance, reduction, sharing, and acceptance.

-*Reducing operational surprises and losses* – Entities gain enhanced capability to identify potential events and establish responses, reducing surprises and associated costs or losses.

-*Identifying and managing multiple and cross-enterprise risks* – Every enterprise faces a myriad of risks affecting different parts of the organization, and enterprise risk management facilitates effective response to the interrelated impacts, and integrated responses to multiple risks.

-*Seizing opportunities* – By considering a full range of potential events, management is positioned to identify and proactively realize opportunities.

-*Improving deployment of capital* – Obtaining robust risk information allows management to effectively assess overall capital needs and enhance capital allocation.

2. Within the context of an entity's established mission or vision, management establishes strategic objectives, selects strategy, and sets aligned objectives cascading through the enterprise. This enterprise risk management framework is geared to achieving an entity's objectives, set forth in four categories:

-*Strategic* – high-level goals, aligned with and supporting its mission.

-*Operations* – effective and efficient use of its resources.

-*Reporting* – reliability of reporting.

-*Compliance* – compliance with applicable laws and regulations.

3. Enterprise risk management consists of eight interrelated components. These are derived from the way management runs an enterprise and are integrated with the management process. These components are:

1. Internal Environment – management sets a risk philosophy and establishes the entity's risk culture and risk appetite.

2. Objective Setting – management considers its risk appetite in the setting of objectives.

3. Event Identification – management identifies the events, both internal and external, that present risk or opportunity to the organization. Opportunities are channeled back to strategy and objective-setting processes.

4. Risk Assessment – the likelihood and impact of risks are assessed to clarify the extent to which they might impact objectives. This employs a combination of qualitative and quantitative methodologies and forms a basis for the management of those risks.

5. Risk Response – management makes the decision as to whether the risk should be avoided, accepted, reduced, or shared; and then develops a set of actions to align the risks with the organization's risk tolerance.

6. Control Activities – policies are established to ensure management's risk responses are carried out effectively.

7. Information and Communication – thorough and timely communication takes place to ensure roles and responsibilities can be performed effectively in the process of identifying, assessing, and responding to risk.

8. Monitoring – ongoing ERM monitoring occurs, and modifications are made as warranted.

When designing and implementing a program of enterprise risk management the company begins by taking an inventory of risk factors pertaining to each driver of success, which may, for example, include financial (including market, credit, and liquidity risks and fraud), operational (including product risks, distribution channels, information security, and business continuity), business (including technological disruption, disintermediation, and competition changes), governance (CEO succession and compliance with laws and regulations), and human resource (employee relations and business conduct and ethics) risks.

Pursuant to the Institute of Internal Auditors (http://www.theiia.org), "[a]lthough the internal auditors do not have primary responsibility for ERM implementation or maintenance, they play an important role in monitoring, examining, evaluating, and reporting on ERM. They also assist management and the board or audit committee by recommending improvements to ERM processes. Internal audit activities may include:

• Reviewing the adequacy and effectiveness of the entity-wide ERM processes (including the processes to identify, analyze, manage, and report on risks) and providing recommendations for improvement.

• Reviewing critical control systems and risk management processes and responses for adequacy and effectiveness.

• Providing advice in the design and improvement of control systems and risk mitigation strategies.

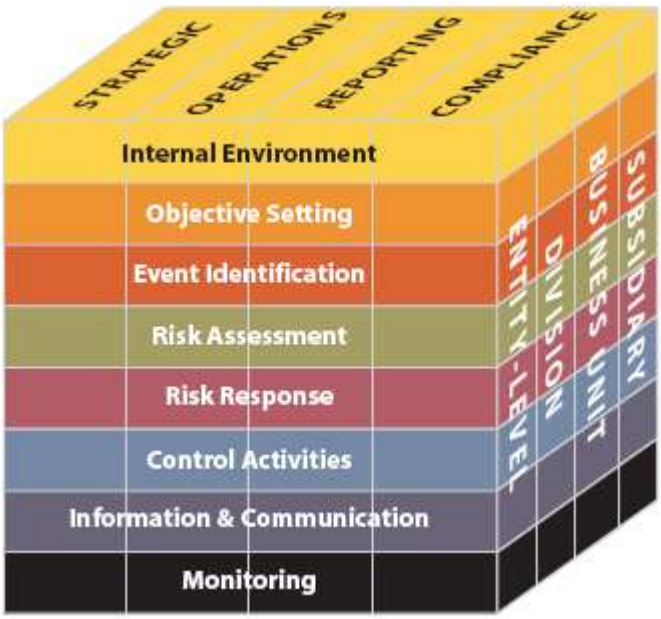
• Implementing a risk-based approach to planning and executing the internal audit process.

• Ensuring that internal audit resources are directed at those areas most important to the organization.

• Challenging the basis of management's risk assessments and evaluating the adequacy and effectiveness of risk-treatment strategies and the reliability of management's assurances.

• Providing assurances on the completeness, accuracy, and appropriateness of management's classification and reporting of risks.
• Facilitating ERM workshops."

The relationship between objectives, which are what an entity strives to achieve, and enterprise risk management components, which represent what is needed to achieve them, has been depicted in a three-dimensional matrix, in the form of a cube that is provided on the next page. The four objectives categories – strategic, operations, reporting, and compliance – are represented by the vertical columns, the eight components by horizontal rows, and an entity's units by the third dimension. This depiction portrays the ability to focus on the entirety of an entity's enterprise risk management, or by objectives category, component, entity unit, or any subset thereof. The eight components will not function identically in every entity. Application in small and mid-size entities, for example, may be less formal and less structured.



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