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

Sarbanes-Oxley expanded to state level

This issue of *Acredula* advises directors and officers on handling information of wrongdoing by or against the organization and advises audit committee members on protecting their statutory right of reliance on others in the audit process.

EDITOR'S NOTE

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As we are going to press, Governor Taft just signed into law House Bill No. 7, which he says will help "build consumer confidence in small public companies." This is Ohio's first legislation expanding the Sarbanes-Oxley Act to the state level. The Bill:

- Increases accountability of at least one individual, presumably an executive officer, for information contained in registrations by description or qualification filed under the Ohio Securities Act. The Bill changes the process of registration of securities by description or registration in Ohio by requiring an individual, rather than the issuer of the securities, to file and execute the application for registration. The individual is to be someone who is fully authorized to execute and file the application for registration on behalf of the issuer. The individual must certify that:
  - He or she executed the application on behalf of the applicant.
  - He or she is fully authorized to execute and file the application on behalf of the applicant.
  - He or she is familiar with the applicant's application.
  - To the best of his or her knowledge, the statements made in the application are true, and the documents submitted with the application are true copies of the original documents.[1]
- Defers the effectiveness of a registration by description until seven business days after the Ohio Division of Securities (ODS) receives the application and filing fee. Before the Bill, a registration by description was effective when filed.
- Prohibits insider transactions that are less favorable to the issuer than third-party transactions and prohibits insider loans by issuers who seek to register their securities by description, qualification, or coordination in Ohio. The Bill authorizes the ODS to refuse any registration if the issuer does not state in its final offering circular that:
  - Any future transaction with an officer, director, five-percent shareholder, manager, trustee, or general partner will be on terms no less favorable to the issuer than could be obtained from an independent third party;
  - Any outstanding loan from the issuer to an officer, director, five-percent shareholder, manager, trustee, or general partner is required to be repaid within six months of the offering, except for a loan or extension of credit made by a bank; and
  - Any future loan from the issuer to an officer, director, five-percent shareholder, manager, trustee, or general partner will be for a *bona fide* business purpose and approved by a majority of the disinterested directors, managers, trustees, or general partners, or will be a type of transaction involving a director or executive officer that is permitted by section 13(k) of the Securities and Exchange Act, as amended by Sarbanes-Oxley.[2]
- Authorizes the ODS to refuse any registration by an issuer that is in the development stage and either has no specific business plan or purpose or has indicated that its business is to engage in a merger or acquisition with an unidentified company or companies, or other entities or persons.[3]

- Makes unlawful knowingly influencing, coercing, manipulating, or misleading any person engaged in the preparation, compilation, review, or audit of financial statements to be used in the purchase or sale of securities for the purpose of rendering the financial statements materially misleading. This applies not only to sales of securities, whether or not registered with the ODS, but also to purchases of securities.[4]
- Enables the Ohio Director of Commerce, if the Director has obtained an injunction against a person for violation of Chapter 1707, after consultation with the Ohio Attorney General to request that court to order the defendants to make restitution for the benefit of the persons damaged by the defendants' actions.[5]
- Increases to five years the outside period of certain statute of limitations. Those increased limitations are for certain actions against investment advisers for self-interest in giving investment advice;[6] for certain actions against directors for an issuer's sale of securities by materially misleading offering materials[7]; for certain actions to rescind a sale and recover the purchase price for securities sold in violation of Chapter 1707[8]; and for the ODS or Director of Commerce to prosecute or take actions for violations of the Ohio Securities Act.[9]
- Amends Ohio's criminal code to make any aggregated theft of property or services of $100,000 but less than $500,000 a third degree felony; to make theft of $500,000 but less than $1 million a second degree felony; and to make theft of $1 million or more a first degree felony.[10]
- Clarifies that any material misstatement in any private offering pursuant to Rule 506 of the SEC is actionable in Ohio to the extent that notice is required to be filed with the ODS with respect to Ohio sales.[11]
- Adds to the definition of security "any oral, written, or electronic agreement, understanding, or opportunity" that represents title to or interest in, or is secured by any lien or charge upon, the capital, assets, profits, property, or credit of an issuer.[12]
- Clarifies with respect to any issuer that is not organized and is not licensed as a foreign corporation under Ohio laws or does not have its principal place of business in the Ohio that the Ohio Secretary of State shall be its agent for service of process notwithstanding any attempt to appoint any other person.[13]
- Clarifies that the enforcement powers of the ODS under Ohio law are cumulative and do not preclude the exercise of any other remedy or authority.[14]
- Although unrelated to corporate accountability, clarifies, with respect to a control share acquisition governed by Ohio law, that the board of the target corporation may reschedule any shareholder meeting requested by the acquiring person if, as a result of a change in the acquiring person's tender offer, the acquiring person is required by applicable SEC rules to extend the offer period.

Endnotes

1 O.R.C. •1707.08, 1707.09.
2 O.R.C. •1707.131(C).
3 O.R.C. •1707.131(B).
4 O.R.C. •1707.41(N).
5 O.R.C. •1707.261.
6 O.R.C. •1707.42(B).
7 O.R.C. •1707.41(D).
8 O.R.C. •1707.43(B).
9 O.R.C. •1707.28.
10 O.R.C. •2913.02
11 O.R.C. •1707.44(B)(6).
12 O.R.C. •1707.01(B).
13 O.R.C. •1707.11.
14 O.R.C. •1707.23(J)

What do you do when you become aware of some wrongdoing?

By
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If you are a director, officer, lawyer, accountant or even a volunteer of any organization—for profit or charitable, taxable or tax-exempt, publicly held or private—you are likely at some point during your service to come across evidence of possible wrongdoing by someone within or associated with the organization. If this happens, what should you do?

For example, let's say this one-page memorandum anonymously comes through an unofficial channel to your attention. How should you handle this situation?

> Sir or Madam:
>
> Mr. CFO is using Reptile LLC and other special purpose entities to divert assets away from the company to compensate himself. Shares of company treasury stock have been pledged to secure loans obtained by these entities. Some of the proceeds of these loans have been paid directly to Mr. CFO. The company is paying for Reptile fees that are being used to pay the interest on these loans. These fees are being accounted for as advisory fees, but none of the other transactions are being reported because the entities are not reflected on the company's balance sheet. Mr. Manager who used to work in the audit department was fired yesterday for raising questions about the accounting of Reptile and for refusing to shred some accounting records. I am incredibly nervous that we will implode in a wave of accounting scandals. Someone should look into this.

This memorandum is similar to one written by Enron's in-house lawyer, Sherron Watkins, to Enron's CEO, Kenneth Lay, which resulted in many of the "accountability" provisions of the Sarbanes-Oxley Act of 2002 (SOX). The intent of Congress in the accountability provisions of SOX was to eliminate an alleged defense by Kenneth Lay that "I had no knowledge" or an alleged defense by Sherron Watkins that "I did nothing further because I trusted him."

Complex maze of corporate governance laws

Although SOX has received much publicity, it is just one law in a complex maze of laws dealing with corporate governance. Other laws dealing with corporate governance include federal and state securities laws that existed before SOX; federal tax laws, especially with respect to tax exempt organizations; standards of professional conduct of lawyers, accountants, internal auditors and other professionals; and state statutory and common law, including fiduciary duties of directors and officers and contractual obligations arising from employment contracts and an organization's governing documents.

Questions you should ask yourself:

(1) What are your duties to the organization?

Why? Because if you do not have a duty to the organization, you may have no obligation. Generally, you only have an obligation to take some action regarding potential wrongdoing by or to the organization if you have a duty of care or duty of loyalty to the organization.

Duties arise from a number of sources, including:

- **State law duties of care and loyalty for directors and officers.** All 50 states have either statutorily or judicially created duties of care and loyalty for directors and officers of an organization. Generally, the duty of care is to act with the care that an ordinarily prudent person in a like position would use under similar circumstances (duty of care). The duty of loyalty is to act in a manner reasonably believed to be in, or not opposed to, the best interests of the organization (duty of loyalty).
- **Contracts.** Duties are often expressed in employment contracts. In addition, contractual duties are often implied from an organization's governing documents, such as codes of business conduct and ethics as well as bylaw and charter provisions (including audit and other committee charters).
- **New and existing federal and state laws.** These include the executive, accountant and lawyer accountability provisions of SOX and section 10A of the Securities Exchange Act of 1934, as well as new state law provisions expanding those accountability provisions to companies other than public reporting companies.
- **New and existing rules of conduct.** These include the rules of conduct governing lawyers, accountants and internal auditors at the state and federal levels through rules of the SEC and the Public Company Accounting Oversight Board (PCAOB) created by SOX.

If you serve as a director, officer, lawyer or accountant for an organization, you likely have duties of care and loyalty that will not allow you to ignore a memo like the one from Sherron Watkins. However, if you serve as a janitor or clerical secretary or in another non-professional, non-directorial position, you probably do not have any legal duty to act on such a memo.

Because of the Sherron Watkins memo to Kenneth Lay, Congress enacted provisions in SOX to require certain persons to take some action:

- **CEOs and CFOs** are required to take action upon learning of a material misstatement in financial statements or reports filed with the SEC, significant deficiencies in internal controls, and any fraud, whether or not material, involving internal controls;
- **Lawyers** for the organization are required to take action upon learning of material violations of securities laws and material breaches of fiduciary duty; and
- **External accountants** are required to take action upon learning of material illegal acts and related party transactions and are required to take action upon learning of defects in internal controls.

Generally, you only have an obligation to take some action regarding potential wrongdoing by or to the organization if you have a duty of care or duty of loyalty to the organization.

(2) What triggers you to take action?

Under most states' laws, whether learning of some possible wrongdoing triggers the need to take action depends upon the duty of care that an ordinarily prudent person in a like position would exercise under similar circumstances. This duty of care applies to any organization, for profit or charitable, taxable or tax-exempt, publicly held or private. The problem with the prudent-person duty of care is that it is open to subjectivity determined by a jury or other trier of facts in courts. For this reason, SOX tries to bring some certainty as to when action must be taken by officers, lawyers and accountants of public reporting companies upon learning of evidence of wrongdoing.

However, what triggers action under SOX is not much different than what courts have held triggers action under the prudent-person duty of care. Under either, any of the following will likely trigger a requirement to take some action:

- Illegal act, generally an act or omission that violates any law, or any rule or regulation having the force of law;[1]
- Violation of securities law or breach of fiduciary duty to the organization or similar violation of federal or state law, including:

- Failure or fraud in maintaining internal control and records underlying the organization's financial statements,[2]
- Improper influence, coercion, manipulation, or misleading of any independent public accountant engaged in the performance of an audit of the organization's financial statements,[3]
- Failure or fraud in reporting by insiders of their trading in the organization's securities,[4]
- Improper trading by insiders in the organization's securities,[5]
- code of business conduct and ethics,[6]
- Unlawful loan to officers or directors,[7]
- Unlawful destruction of documents,[8]
- Unlawful retribution against employees for lawfully providing information in any federal investigation;[9]

• Material misstatement in financial statements or financial report filed with the SEC;[10] and

• Deficiency or fraud in internal controls.[11]

(3) What action has to be taken?

Under most states' laws, the action to be taken depends upon the duty of care that an ordinarily prudent person in a like position would exercise under similar circumstances. Again, the problem with the prudent-person duty of care is that it is open to subjectivity. For this reason, SOX tries to bring some certainty as to what action should be taken. In fact, the rules under SOX dealing with standards of professional conduct of lawyers is instructive.

SOX requires lawyers for public reporting companies to take some action upon learning of evidence of material violations of securities or breaches of fiduciary duty.

SOX requires lawyers for public reporting companies to take some action upon learning of evidence of material violations of securities or breaches of fiduciary duty.[12] The rules dealing with standards of conduct of lawyers under SOX require lawyers to take some action if the evidence is credible and the violation, if true, is material.[13]

These rules dealing with standards of conduct for lawyers are consistent with the holdings of courts across many jurisdictions regarding what a prudent person with a duty of care to an organization should do upon learning of wrongdoing involving or affecting the organization. Therefore, they can serve as guidelines for anyone learning of possible wrongdoing. Whether an organization is publicly or privately held, for profit or charitable, taxable or tax-exempt, a director, officer, professional, or other person having a duty to the organization is likely to act prudently if he or she follows these guidelines:

1. Make an initial inquiry as to:

• **Credibility.** To determine whether the evidence is credible, meaning unreasonable, under the circumstances, for a prudent and competent person not to conclude that it is reasonably likely that a problem has occurred, is ongoing, or is about to occur;[14]

• **Materiality.** To determine whether or not the wrongdoing, if true, would (1) in an absolute sense, be considered material or significant to investors in general or security-holders of the organization in particular or (2) in a relative sense,

- Make any past financial statement or report filed with the SEC materially misleading,
- Have a material effect on any future financial statements or reports filed with the SEC,
- Have, either directly or indirectly because of resulting consumption of time or expense, a material effect on current or future (1) operations, assets, liabilities or prospects of the organization or (2) results of operations or financial condition,
- Constitute a significant defect in the internal controls or records underlying the organization's financial statements, or
- Constitute fraud (whether or not material) involving management or other employees who have a significant role in the issuer's internal controls.

2. If credible and material, then report the evidence of the wrongdoing to the appropriate authorized representative of the organization. If the evidence demonstrates an illegal act or a violation of law or breach of fiduciary duty, report it to the chief legal officer or, if more appropriate, the CEO or CFO. If the evidence shows a misstatement in financial statements or financial report filed with the SEC or another governmental agency, or a deficiency or fraud in internal controls, report it to the CEO or CFO.

3. Request someone responsible to conduct a substantive investigation to determine what remedial measures, if any, are necessary to (1) stop any wrongdoing that is ongoing; (2) prevent any problem that has yet to occur; (3) remedy or otherwise appropriately address any wrongdoing that has already occurred; and (4) minimize the likelihood of any recurrence.[15]

4. Finally, report any remedial measures taken or to be taken to the CEO, CFO and CLO. If the wrongdoing will have a material effect on financial statements, or involves a material misstatement in financial statements or financial report filed with the SEC, or constitutes a significant deficiency in internal controls or accounting records, or involves fraud in internal controls or accounting records, then report remedial

measures to the audit committee or other appropriate committee of the organization's board, or the board itself, and the external auditor.

What would have happened if . . .

What would have happened with Enron if Kenneth Lay had received this type of advice after receiving Sherron Watkins memo?

- Wouldn't he have made at least an initial inquiry to determine the credibility of the evidence and the materiality of the alleged wrongdoing? And, if he did make an initial inquiry, wouldn't he have found the concerns of one of his in-house attorneys credible and her evidence material?
- In any event, wouldn't Sherron Watkins have had a duty to continue up-the-ladder reporting if she did not reasonably believe the matter had been appropriately handled by Kenneth Lay?
- And, wouldn't Sherron Watkins' evidence have been reported to the CLO and likely the audit committee and external auditor?
- Wouldn't a substantive investigation have been undertaken and wouldn't some remedial measures have been taken that could have avoided the Enron implosion.

If Kenneth Lay had received such advice and taken such actions, the fraud perpetrated because of greed at Enron may not have been avoided. However, the fraud may have been discovered two years' earlier, and the implosion of Enron may have been avoided.

Endnotes

[1] •10A(f) of the 1934 Act.
[2] •302 of SOX.
[3] •303 of SOX.
[4] •16(a) of the 1934 Act.
[5] •16(b) of 34 Act and •306 of SOX, including new Regulation BTR.
[6] •406 of SOX; item 406(b)(5) of Regulations S-K and S-B
[7] •402 of SOX.
[8] •802 of SOX and 18 USC 1519
[9] •806 of SOX and 18 USC 1514A
[10] •302(a) (2) –(3) of SOX, 34 Act rules 13a 14(b)(2) –(3) and 15d-14(d) (2) –(3).
[11] •302(a)(5) of SOX, and 34 Act rules 13a-14(b)(5) and 15d-14(d)(5).
[12] •307 of SOX.
[13] 17 CFR •205.2(e).
[14] 17 CFR •205.2(e)
[15] 17 CFR •205(b)(2).

Golden rules for audit committees

By
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Audit committees of public reporting companies subject to the Sarbanes-Oxley Act of 2002 (SOX) and audit committees of all other organizations can satisfy their duties of care by following these "golden rules:"

- Meet separately with each of the three critical participants in the audit process: (1) the CEO, CFO, the chief legal officer and others of management; (2) the internal auditor; and (3) the external auditor; and
- Ask the same questions of each participant and ask each participant about the reliability and competence of the other parties.

Each of these questions is designed to determine the extent that the audit committee may satisfy its duties of care and loyalty in relying upon each of the key participants in the audit process. The first question goes to the reliance and competence of each participant, and the second question goes to the validation of that reliability and competence.

Duties of care and loyalty

Audit committee members, as with other directors of a board, have a duty of care to act as an ordinarily prudent person in a like position would under similar circumstances and have a duty of loyalty to act in a manner reasonably believed to be in, or not opposed to, the best interests of the organization. Under state law, boards and committees are to give "direction" to management through decision making and oversight. Audit committees are not charged by either state law or SOX with managing or participating in the audit. Under SOX and implied by state law, audit committees are responsible for making decisions regarding hiring, firing, compensating and determining the scope of work of the external auditor in the audit process. Their responsibility also includes providing "oversight" so they know what decisions need to be made.

The main participants in the process are described by the Blue Ribbon Committee on Improving Effectiveness of Corporate Audit Committees as a three-legged stool:

> A proper and well-functioning system exists, therefore, when the three main groups responsible for financial reporting—the full board including the audit committee, financial management including the ***internal auditors***, and the outside auditors—form a "three-legged stool" that supports responsible financial disclosure and active and participatory oversight.

Each leg of this three-legged stool is charged with conducting and managing the audit process.

A proper and well-functioning system exists, therefore, when the three main groups responsible for financial reporting form a "three-legged stool" that supports responsible financial disclosure and active and participatory oversight.

Right of reliance on others

As with the board and other board committees, audit committees operate by delegating to others. Most states' laws give audit committee members, and other directors of a board, a statutory right to rely upon:

- *Officers or employees* as to matters for which the director reasonably believes they are reliable and competent;
- *Professionals* such as lawyers or accountants as to matters that the director reasonably believes are within the person's professional competence; and

- *Duly established committees* of the board as to matters within their designated authority that the director reasonably believes merits confidence.

Accordingly, a board is entitled to rely upon the audit committee as to matters within the audit committee's designated authority, which is the purpose of the audit committee's charter. In turn, the audit committee is entitled to rely upon the CFO and internal auditor on matters in which the committee believes the CFO and internal auditor to be reliable and competent and on the external auditor as to matters within the external auditor's professional competence.

Determining reliability and competence

How can an audit committee have a reasonable belief that someone is reliable and competent? By asking questions.

Ask the same questions of all three legs of the audit-process stool: (1) the CFO and others in management; (2) the internal auditor; and (3) the external auditor. Then, compare the answers. The questions should be asked separately of each of the three legs. If the answers are consistent, a committee has strong evidence that it is entitled to rely upon the reliability and competence of each of the three legs. However, it is still advisable to validate reliability and competence by asking all three legs about their view of the reliability of each of the other legs.

If the answers are inconsistent, the audit committee likely has a duty to make further inquiries. First, the committee should review the inconsistent answer of one leg with the other two legs. For example, if an inconsistent answer was received from the CFO, ask the internal and external auditors something like, "Do you know what Mr. CFO may have had in mind when he told us . . . ?" Then, the committee should discuss the inconsistent answer with the CFO, by saying: "When we asked you about XYZ, you said 123, but when we asked the internal and external auditors, they said 789. Can you explain the difference between your answers and theirs?"

Ask the same questions of all three legs of the audit-process stool: (1) the CFO and others in management; (2) the internal auditor; and (3) the external auditor. Then, compare the answers.

This will generally resolve the inconsistencies, especially if the committee validates the reliability and competence of all three legs. However, when in doubt, the committee would be well advised to consult with a lawyer or accountant experienced in audit matters.

Validating reliability and competence

Ask each leg their views on the reliability and competence of the other legs of the stool. Ask the internal auditor, "Based upon your experience, what is your view of the reliability and competence of management in complying with internal controls and preparing financial statements?" Also ask, "Is there anything you think we should know about management or how it is complying with internal controls and preparing financial statements?" Ask the same questions of the external auditor regarding management.

Similarly, ask the external auditor and management about the reliability and competence of the internal auditor. Ask them, "What is your view of the reliability and competence of the internal auditor in carrying out the internal audit function, and is there anything you think we should know about the internal auditor or how it is carrying out the internal audit function?

Finally, ask management and the internal auditor about the reliability and competence of the external auditor. Ask, "What is your view of the reliability and competence of the external auditor in carrying out the audit function, and is there anything you think we should know about the external auditor or how it is carrying out the audit function?"

Sample agenda for year-end meeting of the audit committee

Review Prior to the Meeting:

- Statement of the independent auditor's independence pursuant to Independence Standard No. 1 Independent Discussions with Audit Committees. Note all reported services other than audit services for and relationships other than as independent auditor with the Company.
- Financial statements. Note critical accounting policies applied.
- Audit report on the financial statements. Note the form of the report. Note any variances from an unqualified report, including reliance upon other auditors; changes in accounting principles; qualifications regarding a going concern; and other conditions.
- Independent auditor's report attesting to management's evaluation of internal controls. Note any deficiencies reported and recommendations made and management's follow-up on those deficiencies and recommendations.
- Independent auditor's management or internal control letter.
- Management's Discussion and Analysis (MD&A) of financial condition and results of operations. Note whether the MD&A is consistent with directors' understanding of the business.
- CEO's and CFO's certifications on the accuracy of financial reports and the fair presentation of financial statements.
- CEO's and CFO's evaluation of internal controls and any report of deficiencies. Note any reported deficiencies and actions taken to correct those deficiencies.

Meet with Management to:

- Review with the CEO and CFO their certifications on the accuracy of financial reports and the

fair presentation of financial statements. Ask about actions taken by management to assure accuracy. Also ask about management's definition of materiality for testing purposes.

- Review with the CEO and CFO their evaluation of internal controls and any report of deficiencies. Ask about any deficiencies and actions taken to correct those deficiencies. Ask about the nature, timing and extent of the procedures undertaken by management to support its evaluation regarding the effectiveness of internal controls.
- Have management review key performance measures from each of the financial statements, comparing results to budget, prior year results, analysis expectations and measures used for incentive compensation. Ask about the effect of nonrecurring transactions or events. Ask about adjustments made as a result of the audit and the reasons for such adjustments.
  - With respect to the balance sheet, have management review policies for such items as deferred costs, inventory, receivable reserves, investments, derivatives, acquisitions, fixed asset capitalization and depreciation, intangible assets and goodwill. Have management describe the results of any impairment testing. Have management explain any significant accruals and reserves, and note any changes over time. Ask about any financings, both on and off the balance sheet, and about compliance with any debt covenants.
  - With respect to the income statement, have management describe any significant judgments and estimates that might impact reported results. Have management explain revenue recognition policies. Ask about the effect of any nonrecurring transactions, related party transactions and non-cash transactions.
  - With respect to the cash flow statement, have management analyze the company's liquidity position and projected cash flow relative to cash requirements. Have management review the company's current and historic ratio of net income to cash flow from operations.
  - With respect to the statement of changes in shareholders' equity, have management review any significant changes, especially with respect to issuance of securities, including derivatives and stock options.
  - With respect to the footnotes, have management review significant accounting policies and any changes therein. Have management explain alternative policies, especially policies used by peers, and the impact those policies would have on the company's results. Have management review material commitments and contingencies and explain factors that could result in such contingencies being reflected as an adjustment to earnings. Have management review related party transactions; disclosures regarding acquisitions and investments; federal income taxes, especially variations from statutory rates and the impact of any tax contingencies; assumptions in accounting for pension and post-retirement benefits; litigation; guarantees and indirect obligations; purchase and sale commitments; options and warrants; and derivatives.
- Have management review the independent auditor's management letter and management's response. Ask management's action in response to deficiencies noted or recommendations made by the independent auditor.
- Have management review Management's Discussion and Analysis. Ask about any statements or omissions in the MD&A that are inconsistent with the directors' understanding of the business. Ask whether the independent auditor reviewed the MD&A and whether that review raises any concerns that should be brought to the attention of the audit committee.
- Review with the Company's in-house and, if appropriate, outside legal counsel the Company's compliance with applicable laws including securities laws, and ethical standards. Ask about any legal matter that could have a significant impact on the Company's financial statements.
- Review with appropriate members of management their assessments of the performance by the Internal Auditor and the Independent Auditor.

Have management review key performance measures from each of the financial statements, comparing results to budget, prior year results, analysis expectations and measures used for incentive compensation.

Meet with the Independent Auditor to:

- Review with the independent auditor its statement of independence pursuant to Independence Standard No. 1 Independent Discussions with Audit Committees. Ask about any services other than audit services provided to the Company and relationships other than as independent auditor with the Company.
- Have the independent auditor review its engagement. This review would include the scope and timing of its work; its objectives for the engagement and the extent those objectives were achieved; its responsibilities and those of the internal auditor and management in the process, including the management representations discussed with management and the representations actually made by management; and any limitations on the scope of its engagement. Ask the independent auditor whether it has issued or is contemplating issuing any statement pursuant to:

- Statement of Auditing Standards, as amended by SAS 90, relating to the conduct of the audit; or
- SAS 61, as amended by SAS 90, concerning the independent auditor's judgment about the quality of the Company's accounting principles.

- Review with the independent auditor its report attesting to management's evaluation of internal controls. Ask about the nature, timing and extent of testing performed and the results of such testing. Review with the independent auditor any recommendations made and management's follow-up on those recommendations. Ask whether any deficiencies are of such significance to constitute a condition required to be reported by the independent auditor to the audit committee.
- Have the independent auditor review its audit report. This would include a review of the measures used to determine materiality and the considerations for using that measure; the risks that it assessed and the result of those assessments; the audit's areas of emphasis, such as which accounts or transactions it found subject to material judgments or estimates by management; the types of testing performed, both as to transactions and account balances as well as to internal controls; and the adjustments proposed, those actually made as a result of the audit, and those passed; whether such adjustments were for reason of errors, or variance in judgments or estimates or other reasons, and why any proposed adjustments were passed. Ask the independent auditor whether it encountered any unexpected difficulties during the course of the audit. Ask about the independent auditor's judgment as to the quality, and not just the acceptability, of the accounting principles being used.
- Have the independent auditor review its management letter and management's response. Ask about deficiencies noted or recommendations made by the independent auditor to management and management's action in response to such deficiencies and recommendations.
- Review with the independent auditor its assessments of the performance by the internal auditor.

Meet with the Internal Auditor to:

- Review with the internal auditor any deficiencies found in the internal audit process and the actions of management necessary to correct any internal audit findings.
- Review with the internal auditor its assessment of the performance by the independent auditor.

Conclusion

Although audit committees are not charged by either state law or SOX with managing or participating in the audit, the audit committee is responsible for giving "direction" to management, the internal auditor and the external auditor through decision making and oversight. The audit committee is expected to delegate to officers, employees and professionals. However, in order to be entitled to rely upon these others, the audit committee must reasonably believe that these officers, employees or professionals are reliable and competent.

The best way to determine reliability and competence is to repeatedly ask questions of all the audit participants and compare answers. The best way to validate the committee's assessment of reliability and competence is to ask each of the audit participants about the reliability and competence of the others and, again, compare answers.

The committee may not be able to prevent fraud, but asking these questions may allow the committee to detect fraud early enough to prevent harm to shareholders.

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