



Counsel for
BOARD AND EXECUTIVES

Acredula®



March/April 2005

Vol. VI No. 2

Bricker & Eckler LLP

100 South Third Street
Columbus, Ohio 43215-4291

Phone 614 . 227 . 2300
Fax 614 . 227 . 2390
info@bricker.com
www.bricker.com

COLUMBUS • CLEVELAND

In this issue

- 1 The Audit Process - What You Need to Know as a Committee Member or Officer
- 5 Things to Consider When Becoming a Director

Acredula is the Latin word for "owl," connoting wisdom. This newsletter is intended as wise counsel for boards and executives. Acredula is available to clients and friends of the firm. It is not to be construed as legal advice or opinion.

Potential Directors Have A Lot to Consider

This issue of Acredula continues our series on the role and function of directors and executive officers. The first article focuses on the audit process, in general, and the role of the audit committee and officers, in particular. The second article provides a checklist of what someone should consider before agreeing to become a director. Although, as discussed in the first article, Congress viewed independent oversight by the audit committee as the best line of defense against corporate fraud and mismanagement, Congress did not intend in adopting

EDITOR'S NOTE

John P. Beavers
Partner,
Bricker & Eckler LLP



Sarbanes-Oxley to discourage qualified persons from becoming directors of publicly traded or other companies. However, qualified persons are seeking more guidance before accepting an invitation to become directors, which is the purpose of the second article. The best way to attract and retain qualified persons as directors is to address these issues directly.

The Audit Process - What You Need to Know as a Committee Member or Officer

Complex Maze of Laws

Although the Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) has received much publicity, your responsibilities as an audit committee member or officer are governed by a complex maze of laws. State statutory law, such as the corporation or other governing laws of your state of organization, remains the primary law governing your responsibilities. Your state's governing laws set forth the requirements for your organization's financial statements, your fiduciary duties, and, most importantly, your protections from liability.

Other laws include state common law, such as contract law. You implicitly agree by accepting to serve as an audit committee member or officer of an organization to comply with the organization's governing documents, including its regulations or bylaws, any committee charters, any codes of conduct, and other policies of the organization applicable to you.

You may also have responsibilities under federal securities laws, if your organization is a stock company, or federal tax laws, if your organization is a non-stock or tax-exempt entity. If your organization is in a regulated industry

By
John P. Beavers
 Bricker & Eckler LLP

such as banking or insurance, your responsibilities are also governed by the law governing those industries, such as federal or state banking laws or state insurance laws.

Finally, if you are in a regulated profession, such as accounting or law, your responsibilities are also governed by the ethics and laws governing your profession, such as the Model Rules or Code of Professional Responsibility governing lawyers.

Basic Principle of Sarbanes-Oxley

To understand your responsibilities in a post-Sarbanes-Oxley environment, you should understand the basic principle of Sarbanes-Oxley. This basic principal is that the first and best line of defense against corporate mismanagement and fraud is independent oversight of management by independent directors with the assistance of independent advisers, including independent audits of financial statements by independent auditors, and with accountability of executives for the information provided. In a post-Sarbanes-Oxley environment, the first and best line of offense for good government is also this independent oversight.

The three key areas of oversight that have developed since Sarbanes Oxley are:

1. The financial statement preparation and review processes;
2. Executive compensation; and
3. Board and management succession planning.

These are the key areas for oversight because the life of any organization depends upon:

1. The accuracy of its financial statement;
2. The reasonableness of its compensation; and
3. The appropriateness of its actions taken for succession.

What You Should Know About Directors

The three widely recognized functions of directors are:

- Decision-making regarding matters of policy, direction, strategy and governance;
- Oversight of matters critical to the health of the company on behalf of its stakeholders; and
- Mentorship to the CEO and senior officers.

The two basic duties of directors include:

- The duty of care – Exercising the care that an ordinarily prudent person in a like position would use under similar circumstances; and

- The duty of loyalty-Acting in good faith, in a manner the director reasonably believes to be in (or not opposed to) the best interests of the organization.

The duty of loyalty for directors is a range: from “in the best interests” at one end of the range, to “not opposed to the best interests” at the other end. This range is much broader for directors than it is for officers because corporate and most other state organization laws contemplates that directors, especially those from outside the organization, will have a variety of interests and experience, especially because of the mentorship function.

Directors must identify whose “interests” determine the best interests of their organization. If the organization is a company with stock or other form of ownership, directors must take into account the interests of the shareholders or owners. If the organization is a non-stock or tax-exempt entity with no owners such as shareholders, the best interests of the corporation are determined by the constituencies served by the mission of the corporation.

Directors of most organizations under state law may take into account other interests such as the organization’s employees, suppliers, creditors, and customers, as well as broader interests such as the economy of the state and nation, and community and societal considerations.

There is one important exception in determining what interests are to be served by the duty of loyalty. If the organization is insolvent or within the zone of insolvency, then the interests to be served must include, and in certain circumstance may need to be exclusively, the interests of the organization’s creditors, especially its unsecured creditors. Insolvent generally means liabilities exceeding assets or an inability to pay current obligations as they become due, and being within the zone of insolvency generally means incurring a transaction or failing to take a prudent action is likely to result in such insolvency.

State law provides directors with several protections from liability in exercising their functions and performing their duties, including:

- **The business judgment rule.** Courts do not inquire into the wisdom of actions taken by directors in the absence of self interest, fraud, bad faith, or abuse of discretion. However, this rule requires directors to make a decision – it does not protect directors if they fail to make a decision.
- **The right of reliance on others.** Directors may rely on officers or employees of the organiza-

tion as to matters for which they are reasonably believed to be reliable and competent; legal counsel, public accountants, or other experts as to matters reasonably believed to be within their professional competence; and committees as to matters within their designated authority and that the director reasonably believes to merit confidence.

- **Statutory indemnification.** A director who is successful on the merits or otherwise in defense of any action, suit, or proceeding in which he or she is named by reason of being a director, officer, employee or other agent is entitled to be indemnified against expenses, including attorney's fees incurred in connection with the action, suit, or proceeding.
- **Contractual indemnification.** Broader indemnification than statutory indemnification is permitted if the director acted in good faith; acted in a manner reasonably believed to be in or not opposed to the best interests of the corporation; and with respect to any criminal action or proceeding, had no reasonable cause to believe the person's conduct was unlawful. Broader indemnification includes advancement of expenses, including legal fees and expenses, and indemnification even if the director is not successful on the merits.
- **Director & Officer insurance.** Ohio and most other states' laws permit broader coverage under D&O insurance than under statutory indemnification. Perhaps the most important value of D&O insurance is that it is available even if the corporation is insolvent and even after a change in control.

With respect to nonprofits, volunteer directors (and others) of charitable organizations are immune from civil suits for damages under the Federal Volunteer Protection Act and the Ohio Volunteer Immunity Statute. Volunteer means the director was not compensated other than reimbursement of expenses.

State laws governing corporations and similar organizations contemplate that directors will delegate management of the organization to officers. Accordingly, directors and officers should understand that, in order to be able to rely upon officers when delegating, directors must reasonably believe the officers are reliable and competent in those matters. Although directors may determine competence of an officer based upon the officer's background and experience, directors must ask questions in order to determine reliability of officers.

To comply with their duties under state governing laws, members of the audit committee are well advised to:

- Ask questions designed to verify the reliability of the key participants in the financial statement preparation and audit process, i.e., the CEO, CFO, CLO, any internal auditor, and representative of the external auditor.
- Ask the same questions separately of each of these participants.
- Compare the consistencies of the answers.

Directors should expect that the answers of the various participants will be different depending upon the role and personality of each person. For example, the CEO is likely to describe matters in a big picture and be very optimistic in outlook, while the CLO is more likely to describe details of the matter and be much more cautious in outlook. Therefore, directors should look to the consistency of the answers, feel comfortable to stop asking questions if the answers among the various participants are consistent. However, if the answers are not consistent, directors must delve deeper.

What You Should Know About Officers

Although all of an organization's authority is vested in its board, a board does not directly exercise all of that authority. Instead, it is exercised "under the direction" of the board. Day-to-day running of the organization and its business is the function of officers.

Officers like directors must perform this function with a duty of care and a duty of loyalty similar to those of directors. The duty of loyalty of officers is much higher for officers than it is for directors. While a director's duty of loyalty ranges from being "in" to "not opposed to" the best interests of the organization, an officer's duty of loyalty requires the officer always to act in a manner the officer reasonably believes to be "in" the best interests of the organization.

Officers, more so than directors, have duties created at common law, such as through employment contracts, restrictive covenants and other agreements to which an officer is a party as well the organization's policies and procedures governing officers or employees. Officers are also subject to prohibitions

While a director's duty of loyalty ranges from being "in" to "not opposed to" the best interests of the organization, an officer's duty of loyalty requires the officer always to act in a manner the officer reasonably believes to be "in" the best interests of the organization.

under federal securities laws; federal tax laws, state securities laws, and state regulatory laws if the organization is in a regulated industry.

Sarbanes-Oxley has expanded greatly the accountability of the CEO, CFO and CLO of publicly traded companies. Generally accepted auditing standards are extending this greater accountability to officers of all organizations having audited financial statements. The accountability has been expanded so that the CEO and CFO are to certify to the SEC and investors, with respect to publicly traded companies, or to the external auditor, with respect to other audited organizations, the accuracy and completeness, based upon personal knowledge after review, of the organization's:

- Financial statements;
- Financial disclosures;
- Internal controls; and
- With respect to publicly traded companies, disclosure controls.

The CEO and CFO also have an obligation to "report up" significant deficiencies, material weaknesses and fraud involved in internal controls and disclosure controls.

Additionally, CLOs now have an obligation to investigate or cause investigation of evidence coming to their attention of material violations of law or breaches of fiduciary duty. They, too, have an obligation to "report up" material violations of law or breaches of fiduciary duty.

External auditors now are obligated to "report up" reportable events, including significant deficiencies and material weaknesses in internal controls. In addition, external auditors are obligated to "report up" and, if not corrected, "report out" undisclosed illegal acts and third-party transactions.

State law provides officers, similarly to directors, with several protections from liability in exercising their functions and performing their duties, including statutory indemnification, contractual indemnification, and D&O insurance. However, unlike directors, officers have no protection from the statutory right of reliance or the statutory business judgment rule because state law assumes such executives are accountable for the execution of the business and operations of their organizations.

What You Should Know About the Audit Process

During the audit process, the audit committee is responsible for hiring, discharging, and determining the scope of work and approving the fees of the external auditor. In addition, the audit committee is to oversee management in its responsibilities in the process, including the internal audit process. The audit committee also is the primary recipient of most reports and other communications from the external auditor. Further, the audit committee is responsible for instituting procedures for receiving and investigating risks (including complaints).

Management is responsible for maintaining an effective system of internal controls; maintaining accurate books and records in accordance with GAAP; accurately recording transactions in such books and records, preparing financial statements and related disclosures; allowing unfettered review by the external auditor of such financial statements and, more importantly, the underlying books and records and recording of transactions.

The external auditor is responsible for obtaining objective evidence supporting the amounts and the disclosures in the financial statements; assessing accounting principles used and significant estimates made by management; assessing overall financial statement presentation; and providing an opinion on the overall financial statements. In addition, external auditors perform the following key steps:

- Establishing terms of the engagement;
- Assessing materiality and risks;
- Determining the nature, timing and extent of audit tests (i.e., the audit plan);
- Discussing the audit planning process with the audit committee;
- Performing tests of controls and interim substantive tests of transactions and balances;
- Reassessing the audit plan in light of preliminary testing results;
- Conducting year-end audit testing of transactions and balances;
- Performing final evaluations of conclusions and sufficiency of evidential matter;
- Reviewing financial statements and footnotes;
- Completing quality control review procedures;
- Communicating with management and the audit committee regarding audit results, including audit adjustment proposals and significant deficiencies and material weaknesses in controls; and

Sarbanes-Oxley has expanded greatly the accountability of the CEO, CFO and CLO of publicly traded companies. Generally accepted auditing standards are extending this greater accountability to officers of all organizations having audited financial statements.

- Issuing the financial statement audit report, management letter, and report on internal controls.

The external auditor also communicates with the audit committee regarding judgments and estimates, material accounting policies, significant audit adjustments, other information included in the document with audited financial statements, difficulties encountered during the audit, disagreements with management, auditors judgment about the quality not just the acceptability of accounting principles, illegal acts, reportable conditions with internal controls, and material violation of law or breach of fiduciary duty.

Conclusion

Unfortunately, all of the functions, duties, protections, and processes discussed above set the “minimum” or, at best, “generally accepted” standards to avoid liability for directors and officers. Investors and other stakeholders such as lenders as well as regulators are beginning to expect directors and officers to act with better practices than those minimum or generally accepted standards.

Demand is increasing for greater transparency in financial reporting; more principal-based accounting principles; reduction of interlocking boards or common membership among related organizations; avoidance of self interest in the approval of transactions; fuller disclosure of executive compensation with comparison to performance; and ongoing succession planning for both the board as well as management.

Meeting this demand is essential for restoring confidence in our stock trading markets.

More importantly, restoring confidence in our stock trading markets is essential for avoiding the crises in social security feared by President Bush. Not restoring confidence before the “baby-boomer” population reaches retirement age will result in substantial demands upon the social security system because private pensions will likely not provide adequate retirement income.

Hopefully, all of us will focus on best practices rather than minimum or generally accepted practices in the future.

Things to Consider When Becoming a Director

An individual considering an invitation to join a board should study both the corporation and the board and should accept a directorship only if confident of the competence and integrity of both the top management and the directors of the corporation, as well as his or her own ability to monitor and add value to the enterprise. In considering any such invitation, the individual should thoroughly review the following:

- **Corporation expectations.** Discuss with the CEO and the board chair their expectations for directors, including the frequency, typical duration and scheduled dates of meetings; the availability expected from directors between meetings; any continuing education required of each director; any customer or client referrals expected of each director; and any charitable contributions required of each director.
- **Directors’ qualifying shares.** Determine whether directors are required to purchase or otherwise own a minimum number of shares of capital stock and, if so, whether such shares are to be purchased at market or from the corporation, and, if from the corporation, at what price.
- **D&O insurance.** Determine the type of policy, policy limits (including deductible or retention), and endorsed coverages (securities law liability, ERISA, employment practice) of the corporation’s D&O liability insurance. Have the policy reviewed by a lawyer or insurance consultant. Potential liabilities under federal securities laws as a result of Sarbanes-Oxley can now exceed \$20 million per person.
- **Directors’ indemnification agreement.** Determine whether directors are indemnified by the corporation against liability and the extent of such indemnification. Have any indemnification agreement reviewed by a lawyer.
- **Net worth.** Determine the corporation’s net worth and the extent of its current assets to provide directors’ indemnification.
- **Compensation.** Determine the compensation of board members, including annual retainer and meeting fees (both board and committee); form of payment (cash or stock); ability to defer receipt; and expense reimbursement policy. Typically, compensation is a combination of an annual retainer for time spent in preparing

By
John P. Beavers
Bricker & Eckler LLP

for meetings and meeting fees. The amount of compensation should be commensurate with the work required and risk of liability.

- **Oversight committees.** Determine whether the corporation has required oversight committees (NYSE and Nasdaq require audit, compensation, and nominating committees) and the extent the composition of these committees consists of non-management directors.
- **Audit committee financial expert.** Determine whether the corporation's audit committee has someone meeting the Sarbanes-Oxley definition of an audit committee financial expert.
- **Committee assignments.** Determine committee assignments that you are likely to have. Do you believe you have competency in the matters handled by each such committee?
- **Board vacancies.** Determine whether there are any vacancies on the board, and if so, inquire why.
- **Other independent directors.** Determine the number of directors of non-management directors and their identity.
- **Discussions with other independent directors.** Discuss with other independent directors their perceptions of the corporation's business, the experience and competency of management, and the conduct of board meetings, especially the materials distributed (and whether in advance).
- **External auditor.** Determine the external auditor that audits the corporation's financial

statements and the identity of the audit partner in charge of the corporation's audit. Beginning in 2003, the external auditor of public reporting corporations must be registered with the Public Companies Accounting and Oversight Board.

- **Discussions with the audit partner.** Discuss with the audit partner the corporation's cooperation in the audit process; the critical accounting policies that the auditor believes the board should know; and the effectiveness of the corporation's internal accounting controls.
- **Discussions with management.** Discuss the corporation's prospects with the chief executive, chief financial, and chief legal officers. Determine whether they are competent, reliable and able to work with other directors.
- **Annual report.** Review the notes to financial statements and management discussion and analysis of financial information in the corporation's most recent annual report to shareholders or Form 10-K annual report filed with the SEC. Determine whether the disclosures make sense, whether they are written in understandable English, and whether there are any unanticipated problems.
- **Director orientation.** Inquire whether the corporation will conduct or sponsor any form of orientation for new directors and if so, by whom and when.
- **Analyst reports.** Obtain from your investment counsel and review any recent analyst reports on the corporation. Also see www.bloomberg.com and www.msnbc.com.

Counsel for
BOARDS AND EXECUTIVES

John P. Beavers, Chair
614.227.2361
jbeavers@bricker.com

Jerry O. Allen
614.227.8834
jallen@bricker.com

Alex M. Brown
614.227.2344
abrown@bricker.com

Thomas R. Brownlee, Jr.
614.227.2301
tbrownlee@bricker.com

John W. Cook, III
614.227.2383
jcook@bricker.com

Michael E. Flowers
614.227.2340
mflowers@bricker.com

James F. Flynn
614.227.8855
jfflynn@bricker.com

Michael K. Gire
614.227.2318
mgire@bricker.com

Steven R. Kerber
614.227.2356
skerber@bricker.com

Gordon F. Litt
614.227.2305
glitt@bricker.com

Christine M. Poth
614.227.2395
cpoth@bricker.com

James A. Rutledge
614.227.8830
jrutledge@bricker.com

David C. Spialter
614.227.2342
dspialter@bricker.com

Michael F. Sullivan
614.227.2337
msullivan@bricker.com

Betsy A. Swift
614.227.8850
bswift@bricker.com

Kurtis A. Tunnell
614.227.8837
ktunnell@bricker.com

Faith M. Williams
614.227.2374
fwilliams@bricker.com

Randolph C. Wiseman
614.227.2310
rwiseman@bricker.com