

AUDIT COMMITTEE SELF-EVALUATION PROCESS AND FORMAT (AND FOR BOARDS AND OTHER COMMITTEES)

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Self-evaluation is an important board and committee activity, and can be very helpful if done properly.

A. Introduction and Overview

The following discussion specifically covers audit committee self-evaluations and provides processes that you can use – this discussion can also be used for board and other committee self-evaluations and processes, such as for governance and risk committees. As noted elsewhere in these materials, although many board and audit committee functions, responsibilities and tasks are specified by statute, regulation, rule or pronouncement, board and audit committee member standards of care remain significantly dependent on due diligence and prudent judgment.

Boards, audit committees and other committees of various entities are required by law, regulation or rule to conduct annual committee self-evaluations; however, it is worthwhile for boards, audit committees and other committees of all public and private companies and nonprofit entities to conduct self-evaluations. Board committee jobs are challenging, ongoing, and

technical in nature, and require the members to significantly interact with many people in different capacities within and outside of the entity. It only makes sense that boards and committees should at least once each year take time to step back and review, evaluate and make improvements to their manners of operation, and also consider helpful actions that can be taken by other people with whom the board, audit committee, or other committee interacts. Self-evaluation will be worthwhile even if it results in improving only one area of operation.

Board and committee responsibilities originate from several different sources at least including (1) activities and responsibilities that boards or committees voluntarily undertake or that are delegated to them; (2) the business judgment rule; (3) the specific laws, regulations and rules that are applicable to the entity's directors and committee members; (4) the wording of the board and committee charters, if there are charters; (5) shareholder and stakeholder expectations, and (6) for audit committees, accounting and auditing pronouncements relating to the outside auditor's activities.

Prudent board and committee processes and diligence are also important to reduce member and entity liability and reputation risk. An increasing number of cases hold that board and audit committee members can be liable for failure to exercise sufficient diligence, failure to spot and respond to red flags, and failure to take action. Active board, committee and corporate diligence tend to demonstrate prudent business judgment and negate allegations of recklessness, improper intent, intentional wrongdoing, or "scienter" such as in the context of securities litigation, thus reducing the risk of securities liability and damages. In the context of audit committee activities, potential entity, board, and audit committee member liability typically arises in the context of alleged improper accounting practices, written and oral public misrepresentations (such as with respect to financial matters), and improper employment practices.

Although not required, there can be advantages to having a facilitator conduct an interactive interview approach to the self-evaluation process, but 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 in the self-evaluation process; different people use different rating scales; different people express responses in different manners; and certain important issues will change from year to year. A facilitated approach may encourage better discussion and comment, compilation, continuity, explanation, and follow-up. Contact me if you are interested in committee self-evaluation assistance at a reasonable fixed fee.

Issues and topic areas to consider during the self-evaluation process will naturally vary from entity to entity, and from board, audit committee or other committee to board, audit committee or other committee. Thus, to stimulate discussion, below for both boards and audit committees I have provided lists of potential broad issues or topic areas to consider for discussion and evaluation, including both successes and possible improvements; and I have also outlined processes to assist your board and audit committee self-evaluation processes.

B. Audit Committee Self-Evaluation

1. Sample List of Issues and Topics to Consider for Audit Committee Self-Evaluation

The following is a list of issues and topic areas to consider for discussion and evaluation. The list is intended to help trigger thought processes, but, of course, is not exhaustive as areas of discussion and evaluation will vary from entity to entity, and from committee to committee. The following list is not intended to and does not suggest that each or any of the below issues and topics must be considered or covered and is not a checklist – instead, if your audit committee is required to conduct a specific evaluation process or to cover certain specific issues and topics, you will need to separately consider the specific requirements, if any, for your audit committee and its evaluation process pursuant to law, regulation or rule. In that regard, please also see the disclaimer and limitations at the beginning of these materials.

- Audit committee meeting agenda preparation and dissemination process.

- Committee member independence and situational independence, financial literacy, experience and expertise.

- Committee member access to information and/or education pertinent to the functions and responsibilities of the audit committee. Are the needs of the committee members being met, so that they are sufficiently knowledgeable and educated about the company or nonprofit and its industry; relevant significant accounting and auditing issues; relevant legal matters; internal controls, risk assessment and management; governance; and new developments in those and other areas?

- Review of committee and committee member interactions and communications, including interactions and communications between committee members, and between the committee and the board, the CEO, the CFO, the outside auditor, the internal auditor, legal counsel, compliance and ethics, HR, consultants, and other people.

- The committee's processes for identifying and spotting issues, evaluation and decision making.

- The contents of the audit committee charter, and a mutual understanding of the audit committee's responsibilities and tasks. The charter is a requirement for public companies, and is a good idea for many private companies and nonprofit entities. The charter is a prudent document to identify and clarify the audit committee's responsibilities. In addition to the committee itself, it is important for the board, the executive officers, and other stakeholders to have a correct understanding about the committee's responsibilities and limitations, and the extent to which state or local jurisdiction, U.S. and international requirements and responsibilities apply or may apply to your audit committee.

- Selection of the outside auditor; audit planning; review of the performance of the outside auditor; and review of the quarterly review and annual audit report and process (or compilation if appropriate).

- Review of recent developments relating to the business judgment rule, standard of care and acceptable reliance on other people.

- Review of accounting and financial internal and fraud/embezzlement related controls and processes, risk assessment and management, possible entity and individual liability and reputation risk exposure; and compliance assessment and management relating to laws, regulations, and rules that are within the scope of the audit committee's functions and responsibilities including issues relating to the Foreign Corrupt Practices Act.
- Review of the accounting department, and accounting and financial reporting for transactions including all of the subcomponents such as principles and policies applied (quality not just acceptability); judgments, estimates and reserves; timing and cutoff procedures; off balance sheet transactions; related party transactions; contingencies and liabilities; revenue recognition; expenses; inventories; goodwill; insider trading; and other matters relating to accounting and financial statement reports.
- Implementing revenue recognition rules, and other important, new or changing accounting principles.
- Review of internal investigation processes, procedures and needs.
- Review of the financial and internal audit functions, and how they can be helpful to the audit committee in the performance of its responsibilities and tasks.
- Review of disclosures that accompany the financial statements, and review of other financial or financial statement related disclosures that are within the scope of the audit committee's function and responsibilities.
- Review of committee member actual or possible situational conflict of interest and independence, including the possible need for a special committee, and possible additional or new members for a special committee, such as in particular situations or investigations or M&A, etc.
- Review of risk management and uncertainty issues, practices and processes that are within the scope of the audit committee's function and responsibilities.
- Implementing COSO 2013 or other appropriate processes.
- Documenting and reporting the audit committee's activities and minutes.
- The audit committee's use of attorneys and consultants.
- The company's investor communication processes.
- Whistleblower, ethics, anonymous reporting and complaint handling processes to the extent that the reporting is within the scope of the audit committee's function and responsibilities.
- Document retention policies.

- Review of the compliance and ethics function and processes that are within the scope of the audit committee's responsibilities, and how they can be helpful to the audit committee in the performance of its responsibilities and tasks.
- Governance, including tone at the top, financial leadership, transparency and appearance.
- Review of employer, employee and workplace processes, culture, safety, and disciplinary practices that are within the scope of the audit committee's function and responsibilities.
- Review of tax compliance and reporting issues that are within the scope of the audit committee's function and responsibilities.
- Review of cybersecurity and internet security issues that are within the scope of the audit committee's function and responsibilities.
- Insurance.
- Review of pension and health plan related issues that are within the scope of the audit committee's function and responsibilities.
- Review of information privacy issues, practices and processes that are within the scope of the audit committee's function and responsibilities.
- Review of asset protection, IP, trade secret, etc. practices to the extent that they are within the audit committee's function and responsibilities.
- Review of environmental issues and safety that are within the scope of the audit committee's function and responsibilities.
- Review of product and consumer safety issues, practices and processes that are within the scope of the audit committee's function and responsibilities.
- Review of ESG, ESG processes, and ESG discussions and disclosures that are within the scope of the audit committee's function and responsibilities.
- Review of billing and accounting relating to the receipt of funds or revenue from governmental sources such as Medicare and Medicaid; compliance with applicable laws, regulations, rules and other requirements; and oversight of expenses relating to these areas.
- Review of the acceptance, receipt, allocation, expenditure or distribution, and accounting for all charitable and donor funds, grants, contributions, pledges and other resources, including compliance with all requirements, restrictions and special uses.
- Review of accounting for collaboration and joint venture arrangements, including the allocation of receipts/income and distributions/expenses between the entities.

-And, in this economic environment, review of the fair value of funds and investments, including loss of value; liquidity concerns; possible going concern issues; estimates for uncollectibles and related reserves; debt/loan covenants; and funding source uncertainties including those that relate to collaboration and joint venture arrangements.

-It is also important for the audit committee to clarify with the board what responsibilities it has, if any, for oversight of the numerous and various areas of taxation and compliance; ERISA, pension and health and welfare plans; investments; tax exempt status including fund raising, dues, solicitation, and political, campaign and lobby activities; and other areas significant to the entity.

-Discussion about audit committee membership and recruitment needs.

-Additional significant topics or issues that should be discussed.

2. A Self-Evaluation Process and Format for Audit Committees (and for Boards and Other Committees)

The following eight primary steps outline a proposed audit committee self-evaluation process that is workable for audit committees of public companies, private companies and nonprofit entities, whether using or not using, an outside facilitator.

Step 1. Determine the people who will be participating in the evaluation process, including the audit committee members, and other people, if any, to interview for comment.

Provide the names of the people who will participate in the evaluation process.

Step 2. Determine how the participant interviews will be conducted, individually or in a group, in person or by telephone, skype or some other means.

Provide comments or information about how the interviews will be handled with the various different people who will participate in the evaluation.

Step 3. Arrange participant individual or group interview dates and times.

Provide participant individual or group interview date and time information.

Step 4. Provide the participants with pre-interview materials and a list of possible issue or topic areas (broad and specific) for consideration and discussion. Of course, the participants can add additional issues or topics. Use this paper for that purpose.

Provide information regarding the status of disseminating the pre-interview materials.

Step 5. Have each participant provide a list of one to five, or more, issues or topic areas that the participant would specifically like to discuss during the evaluation process.

Provide comments and information regarding receipt of issues or topic areas from the self-evaluation process participants, and the respective issues or topic areas listed.

Step 6. Conduct information intake or interviews with participants individually or as a group.

Provide comments and information from the participants or the status of such – the input can be made by the participants themselves or by a facilitator during self-evaluation interviews.

Step 7. Summarize in a report format the issues and topic areas, information received, and suggestions made during the self-evaluation process.

Provide a summary in a report format.

Step 8. Provide a report back to the audit committee, and possibly conduct a committee group review of the self-evaluation process, information obtained, and suggestions made, and possible future actions or follow-up.

Provide additional comments and information about the self-evaluation process or results.

Concluding comments. I hope you have found this discussion helpful and at least a good starting point for your audit committee self-evaluation. Feel free to contact me if you are interested in discussing board, audit committee, or other committee self-evaluation process, or if you would like help with facilitation of committee self-evaluation at a reasonable fixed fee.

Best to you,

David Tate, Esq.

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