Nonprofit Board and Director Standard of Care

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The following materials apply to nonprofit board members in general and specifically in California, and also include materials about provisions of the California Nonprofit Integrity Act, risk management, and audit committees. Please feel free to pass this paper to other people who would be interested.

Overview of Contents:

The obligatory disclaimer: These materials do not provide legal, accounting or other professional advice, and are not a solicitation for work. These materials do not apply to any particular person, entity, event, transaction or situation. As these materials are only a summary of technical and detailed subject matters, and are updated and changed periodically, 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 these summary materials to guide your situation or your actions.

1. The Business Judgment Standard of Care and Fiduciary Duty

The Business Judgment Rule

The business judgment rule provides a director with a defense to personal liability, holding that as a general principle of law, a director, including a director who serves as a member of a board committee, who satisfies the business judgment rule has satisfied his or her duties. Thus, the business judgment rule provides one general standard of care, although other standards may also apply. In some states the business judgment rule is codified by statute, such as Cal. Corp. Code §309 for California corporations; in other states the rule is established by case law. The rule also applies to directors as board committee members.

In summary, as a general principle 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.

Reliance Upon Other People Under the Business Judgment Rule

In the course and scope of performing his or her duties, a director must necessarily obtain information from and rely upon other people. The director is not involved in the day-to-day operations of the business. The director provides an oversight function. Pursuant to the business judgment rule, a director 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.

The Business Judgment Rule for California Nonprofits

California Corporations Code §5231, for nonprofit public benefit corporations, and §7231, for nonprofit mutual benefit corporations, in pertinent part provide that:

(a) A director shall perform the duties of a director, including duties as a member of any committee of the board upon which the director may serve, in good faith, in a manner such director believes to be in the best interests of the corporation and with such care, including reasonable inquiry, as an ordinarily prudent person in a like position would use under similar circumstances.

Reliance Upon Other People Under the Business Judgment Rule for California Nonprofits

California Corporations Code §5231, for nonprofit public benefit corporations, and §7231, for nonprofit mutual benefit corporations, in pertinent part provide that:

(b) In performing the duties of a director, a director shall be entitled to rely on information, opinions, reports or statements, including financial statements and other financial data, in each case prepared or presented by: (1) one or more officers or employees of the corporation whom the director believes to be reliable and competent in the matters presented; (2) counsel, independent accountants or other persons as to matters which the director believes to be within such person's professional or expert competence; or (3) a committee of the board upon which the director does not serve, as to matters within its designated authority, which committee the director believes to merit confidence, so long as, in any such case, the director acts in good faith, after reasonable inquiry when the need therefore is indicated by the circumstances and without knowledge that would cause such reliance to be unwarranted. I have underlined part (3) above because it is important to understand that although a committee to which a task or responsibility has been delegated can do most of the work, the board still should receive a report or recommendation from the committee about the committee's important matters, prudently discuss and inquire about the report and/or recommendations, and approve them or refer for further work or considerations. In other words, the board should not simply punt decision making on important matters to the committee. Further, from a committee member's perspective, to ensure that everyone is on board and on the same page, I would want to make sure that the board is engaged, understands, and approves of the ongoing actions and recommendations of the committee close in time to when those actions and recommendations occur.

Thus, the business judgment standard for a board member of a nonprofit entity requires the director**,** including a board member who serves on a committee such as an audit committee member**,** to perform duties loyally, in good faith, without self-interest, in a manner that the director believes to be in the best interests of the entity, and with the care, including reasonable inquiry, as an ordinary prudent person in a like position would use under similar circumstances.

A director may not close his or her eyes to what is going on with respect to the entity's business and financial affairs. The director has a duty to be proactive. In relying on the opinions or reports of other people, the director also must act in good faith, conduct reasonable inquiry, and be free of any knowledge that would cause reliance on data and reports received from others to be unwarranted. "In a like position . . . under similar circumstances" refers to the situation that exists at that time, including the individual director's knowledge, experience and expertise. Thus, cases have held that a director who has specific expertise may be expected to use that expertise.

The Business Judgment Rule for California Nonprofit Religious Corporations

California Corporations Code §9241 contains similar language for nonprofit religious corporations. However, §9241 replaces ". . . as an ordinarily prudent person in a like position would use under similar circumstances", with ". . . as is appropriate under the circumstances." Section 9241 also allows for appropriate reliance on "religious authorities and ministers, priests, rabbis, or other persons . . . ."

Of course, the business judgment rule does not tell or educate a director about the specific tasks and actions to undertake to satisfy his or her director fiduciary duties. And except as otherwise discussed herein, those tasks and actions are too diverse and numerous to cover in this paper; however, in broad terms I characterize a director's duty as being a member of the board which is responsible for oversight of the entity's processes and functions pertaining to strategy, governance, accounting and financial statements, finance, risk management, compliance with laws, statutes, regulations and rules, and talent/succession.

2. The California Nonprofit Integrity Act

Provisions Pertaining to Financial Statements, Audits and Audit Committees

The entire board is responsible for oversight of the nonprofit's accounting system and financial statements, including if there is an audit of the financial statements; however, as discussed above, the board may delegate responsibility to a committee such as the audit committee, but with continuing board oversight. If the board delegates responsibilities to the audit committee, the board nevertheless should be informed about the significant activities and recommendations of the audit committee, and should approve those activities and recommendations.

The audit committee is a sub-committee of the board. Members of the audit committee are directors, as a general matter, although in one instance I served as an audit committee chair of a nonprofit but not as an overall board member where the nonprofit wanted a completely independent audit committee chair. As the business judgment rule applies to directors, the rule also provides a general standard of care for audit committee members. For the most part, the activities that a nonprofit audit committee is required to perform are unspecified. The committee's activities will depend on the financial size of the nonprofit, the requirements and expectations of the sources of funds (governmental and non-governmental), the type of outside auditor financial statement evaluation required (i.e., audit, review, compilation), and the expertise of the board and audit committee members. Depending on the circumstances, the financial statements of a nonprofit may require an audit (and possibly an enhanced government OMB A-133, or single audit), review or compilation, or a combination thereof. In California the Nonprofit Integrity Act provides additional statutory requirements.

With respect to nonprofit financial statements, audits and audit committees, the California Nonprofit Integrity Act at Cal. Gov. Code §12586 in part requires:

-Specified charitable corporations, unincorporated associations and trustees, that receive or accrue in any fiscal year gross revenues of $2,000,000 or more (exclusive of grants from, and contracts for services with, governmental entities for which the government requires an accounting of the funds received) to have annual financial statements, using generally accepted accounting principles, that are audited by an independent certified public accountant (adhering to the Government Auditing Standards, U.S. Comptroller General, Yellow Book) in conformity with generally accepted auditing standards. The Office of the Attorney General has stated that the audited financial statements and notes to the statements must be released to the public, but not the management letter which is not part of the audited financial statements; and that gross revenue is the same as total revenue which appears on Line 12 of IRS Form 990 for public charities, and Line 12, column (a) for private foundations (follow Form 990 and 990PF instructions).

-Each such nonprofit corporation must have an audit committee appointed by the board of directors. The audit committee may include people who are not members of the board, but may not include any members of the staff, including the president, chief executive officer, treasurer or chief financial officer. If the charitable corporation has a finance committee, the audit committee must be separate from the finance committee. Members of the finance committee may serve on the audit committee, but the chair of the audit committee may not be a member of the finance committee, and finance committee members must comprise less than one-half of the membership of the audit committee. The California Office of the Attorney General has stated that there is no requirement that the entity have a particular number of audit committee members—however, I suggest that there be three or more members to promote expertise, discussion, interaction and feedback.

-Members of the audit committee cannot receive any compensation from the charity in excess of the compensation, if any, received by members of the board for service on the board, and shall not have a material financial interest in any entity doing business with the charity.

-Subject to the supervision of the board, the audit committee shall recommend to the board the retention and termination of the outside auditor, and may negotiate the outside auditor's compensation, on behalf of the board.

-The audit committee shall confer with the outside auditor to satisfy its members that the financial affairs of the nonprofit are in order, and shall review and determine whether to accept the audit, shall assure that any non-audit services performed by the auditing firm conform with standards for auditor independence, and shall approve performance of any non-audit services by the auditing firm.

Provisions Pertaining to Executive Compensation

California Government Code §12586(g) provides that the board of directors of a charitable corporation or an authorized committee of the board shall review and approve the compensation, including benefits, of the president or chief executive officer, and of the treasurer or chief financial officer to assure that it is just and reasonable. The review and approval shall occur initially upon hiring, whenever the term of employment is renewed or extended, and whenever the officer’s compensation is modified. Separate review and approval is not required if a modification of compensation extends to substantially all employees. If the charitable corporation is affiliated with other charitable corporations, the review and approval requirements will be satisfied if review and approval is obtained from the board or from an authorized committee of the board of the charitable corporation that makes the retention and compensation decisions about the officer in question.

Provisions Pertaining to Fundraising

California Government Code §§12599 through 12599.7 contain detailed requirements pertaining to certain fundraising activities. The following is an overview of the provisions.

-Commercial fundraisers must notify the California Attorney General before starting a solicitation campaign.

-Commercial fundraisers for charitable purposes must report and provide required information to the Attorney General's Registry of Charitable Trusts the start of a solicitation campaign or event not less than 10 working days prior to the start of a solicitation campaign or event or no later than the date on which the campaign begins if the proceeds are intended for victims of disasters or emergencies.

-For every solicitation campaign or event produced by a commercial fundraiser for a charitable organization, there must be a written contract, satisfying specific statutory terms and requirements, between the fundraiser and the charitable organization.

-The contract must be signed by the commercial fundraiser's authorized contracting officer and an official of the charitable organization authorized to sign by the governing board.

-Contracts between commercial fundraisers for charitable purposes and charitable organizations are voidable unless the commercial fundraiser is registered with the Attorney General's Registry of Charitable Trusts prior to the start of the solicitation campaign or event.

-Fundraising counsel must file a notice and provide information with the Attorney General's Registry of Charitable Trusts not less than 10 working days prior to the start of a solicitation campaign or event; or if the purpose is to raise funds for victims of disasters or emergencies, no later than the date on which the campaign begins.

-For every solicitation campaign or event, there must be a written contract, satisfying specific statutory terms and requirements, between the fundraising counsel and the charitable organization. The contract must be signed by the fundraising counsel's authorized contracting officer and an official of the charitable organization authorized to sign by the governing board.

-Charitable organizations have the right to cancel a contract with a commercial fundraiser without liability for 10 days following the date the contract is executed.

-Following the initial 10-day period, charitable organizations have the right to cancel a contract with a commercial fundraiser by providing 30-day notice. The charitable organization is liable for services provided by the commercial fundraiser up to 30 days after the notice is served.

-Following the initial 10-day period, a charitable organization has the right to cancel a contract with a commercial fundraiser without liability if the commercial fundraiser or its agents make material misrepresentations during a solicitation, harm the charitable organization's reputation during a solicitation, or are found to have been convicted of a crime arising from fundraising activities.

-Charitable organizations and commercials fundraisers cannot misrepresent the purpose of a charitable organization, or the nature or purpose of the beneficiary of a solicitation.

-Charitable organizations must establish and exercise control over fundraising activities conducted for their benefit. This obligation includes approving all written contracts and agreements, and assuring fundraising activities are conducted without coercion.

-Charitable organizations cannot enter into any contract or agreement with a commercial fundraiser that is not registered with the Attorney Generals Registry of Charitable Trusts.

-Charitable organizations cannot raise funds for any charitable organization required to be registered with the Attorney Generals Registry of Charitable Trusts unless the charitable organization is so registered or, if not, agrees to register prior to the start of a solicitation.

-Commercial fundraisers must, within five working days, either deposit in a bank account controlled by the charitable organization or deliver personally to the charitable organization all contributions received on behalf of the charitable organization.

-The following acts are prohibited in the planning, conduct or execution of solicitation campaigns:

-Operating in violation of the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Cal. Gov. Code §12580, et seq.), regulations and orders issued by the Attorney General.

-Committing unfair or deceptive acts, or engaging in fraudulent conduct.

-Using any name, symbol, emblem or other information that falsely suggests or implies a contribution is for a particular charitable organization.

-Falsely telling donors that a contribution is for a charitable organization or will be used for a charitable purpose.

-Telling donors that a person sponsors, endorses or approves a charitable solicitation when that person has not agreed in writing to have their name used for such a purpose.

-Misrepresenting that goods or services have endorsements, sponsorships, approvals, characteristics or qualities they do not have.

-Misrepresenting that a person has endorsements, approvals, sponsorships, status or affiliations they do not have.

-Misrepresenting that registration with the Attorney Generals Registry of Charitable Trusts constitutes an endorsement or approval by the Attorney General.

-Representing that a charitable organization will receive an amount greater than the reasonably estimated net proceeds from a solicitation campaign or event.

-Issuing cards, stickers, emblems, plates or other items that can be used for display on a motor vehicle, and which suggest an affiliation with, or endorsement by, public safety personnel or a group of public safety personnel.

-Representing that any portion of contributions solicited by a charitable organization will be given to another charitable organization unless the second charitable organization provides prior written consent for such use of its name.

-Representing that tickets to events will be donated for use by another person or entity unless: the charitable organization or commercial fundraiser has obtained written commitments from charitable organizations that they will accept a specific number of donated tickets; and the donated tickets, when combined with other ticket donations, do exceed either the ticket donations received from charitable organizations or the total capacity of the event site.

-Commercials must maintain for at least 10 years following each solicitation campaign records that contain:

-The date and amount of each cash contribution.

-The date, amount, name and address of each non-cash contributor.

-The name and address of each employee or agent involved.

-Documentation of all revenue received and expenses incurred.

-For each account into which the fundraiser deposited revenue, the account number and name and location of the bank or other financial institution in which the account was maintained.

3. Risk Management

Risk management is a broad subject matter area—there is also no agreed upon definition or process for risk management. While there is no statutory requirement that the nonprofit board exercise oversight of risk management, it is, or is becoming, an accepted practice that risk oversight is a board function. Further, by statute or rule (and/or accepted prudence or standard in the industry) many organizations are now legally or quasi-legally required to exercise formal risk management, with board oversight. It is also not uncommon for the board to delegate risk oversight to a board committee, such as the audit committee; however, the board should remain engaged in risk management oversight even if preliminary responsibility is delegated to a board committee.

What is risk management and what does it include? There is no standard answer, and I am not proposing one in this paper as that is not the objective of this discussion. The objective in this paper is for the organization to consider and improve upon its risk management processes. Risk management is a process—or, more correctly stated, risk management is the processes—that are designed and implemented to help the organization achieve its mission, objectives and strategies—to get to where it wants to go. There can be a tendency to view risk management only from a liability avoidance perspective. While it is true that an aspect of risk management does involve avoiding and handling liability or potential liability situations, risk management is more broad in scope. Every organization has risk. Risk is a part of operations and business. Simplistically, there is risk that an event or an objective might not occur or might not occur as desired, when desired or to the extent desired—there is risk that an objective might be exceeded or that an unexpected desirable event occurs or opportunity arises—there is risk that a negative event may occur or that an event or objective will not be achieved. Of course, even with the "best" of risk management processes unexpectancies will occur—the occurrence of an unexpectancy, even a negative unexpectancy, does not mean that someone is at fault or that someone acted improperly.

Some risks and risk management processes are generally shared or similar across organizations and industries, whereas, of course, within organizations and industries risks and risk management processes obviously will vary.

Start by listing the organization's mission, objectives, strategies, and projects, and identifying and preparing a list of the risk factors that impact or could impact the organization in relation to achieving its mission, objectives, strategies and projects. The list is endless. First concentrate on what I would consider the most significant ones based on likelihood of occurrence (based on current conditions), likelihood of occurrence within a particular time frame, and potential for impact upon occurrence. An event or unexpectancy with a high likelihood of occurrence, even within the immediate future, but with little likely impact, probably is not as important to deal with right away as an event that has much less likelihood of occurrence (based on current conditions) but that carries the potential for high impact. This gets into the areas of risk assessment, appetite and tolerance. I do not like the terms risk appetite and risk tolerance – although apparently they are terms that are accepted for the purpose of risk management, they can be used to imply after the fact that the organization or board thought that the risk of an incident occurring was okay or acceptable.

The following is one recent risk management occurrence example. By historical standards the likelihood of a gulf oil spill might be slight, but the likely impact could be catastrophic. Of course, historical standards of likelihood could be an erroneous criteria as based on then existing current conditions (i.e., the then existing conditions of the equipment being used, training, and safety procedures—possible leading indicators of the risk event), the likelihood of occurrence might have been higher. Leaks can happen although we all wish not; however, three would be no appetite or tolerance for the occurrence of a significant spill—presumably processes for addressing and preventing the risk of possible spill occurrence, and processes for emergency containment and remedial actions in the event of such a spill would be given the highest priorities.

We don't want to get bogged down in a technical discussion about risk management as the objective here is to encourage the organization to consider and improve upon its risk management processes. For the purpose of an exercise, let's take the example of a hypothetical nonprofit that provides assistance to people in need who are of low or no income. In part, the nonprofit runs a care clinic. The clinic is staffed with volunteers and with licensed care professionals who provide their time and services at a reduced rate. The nonprofit primarily receives revenue/receipts from donations, from a government contract with the city which pays for care provided to qualifying patients who access the clinic on a per-patient basis (the city contract covers a little over half of the costs of operating the clinic), and from insurance and public benefit reimbursements. The nonprofit's mission is also in part religious.

Some of the nonprofit's objectives and risks that quickly come to mind are: securing a timely stream of revenues/receipts/donations from the various available sources; identifying the care that will be provided and maintaining the quality and timeliness of diagnosis and care; proper discharge and/or referral of patients; satisfying the specific requirements of the contract with the city; medical record security and privacy; satisfying HR requirements; satisfying legal requirements and adopting compliance programs and processes; maintaining the religious aspect of the organization's mission; obtaining appropriate liability and risk insurance coverage; and proper and timely transaction recording, accounting records, internal controls and financial reports and statements.

For an outline of a risk management process, please see my 1-page risk and uncertainty management process and oversight paper.

4. <u>Audit Committees</u>

Oversight of the accounting function and the financial statements is a board function. Some nonprofit boards have audit subcommittees, some don't and in California some are required to have audit committees pursuant to the Nonprofit Integrity Act. There is very little guidance that specifies how a nonprofit board or audit committee should go about satisfying the accounting function and financial statement oversight. Just for example, some nonprofits have or are required to have their financial statements audited such as pursuant to the Nonprofit Integrity Act, whereas other nonprofits are not required to have audits and may or may not have their financial statements reviewed or compiled. Depending on the circumstances and the type or amount of governmental receipts or revenues that the nonprofit receives, the financial statements of a nonprofit also may require an enhanced government OMB A-133, or single audit. And nonprofits also generally don't have internal audit functions which could help the audit committee with its oversight function.

So how does a nonprofit audit committee go about satisfying its oversight function? First, I recommend that there be an audit committee charter. A real charter which lists what the audit committee will do and oversee, and in appropriate circumstances items or functions that the audit committee will not perform or oversee. For example, if the audit committee is designated as being responsible for risk management oversight and reporting back to the board about risk management, the charter and the stakeholders such as the board members, the audit committee, the CFO and/or Controller, the CEO or President and other involved people need to understand exactly what that oversight covers.

The audit committee should want to be comfortable that the people who are performing the CFO, Controller, accounting and financial statement tasks and functions are qualified and are performing their tasks and functions properly.

The audit committee should want to be comfortable that internal controls in place are sufficient and excellent. I don't want to get too complicated, but take a look at COSO 2013.

The audit committee should want to be comfortable that the outside auditor, if there is one, is performing those services with excellence. An audit committee member isn't involved in the day-to-day operations, the design, implementation or monitoring of the internal controls, the recording of accounting entries, or the preparation of the financial statements. The board, and the audit committee and its members truly are dependent on the outside auditor doing an excellent job.

Obviously an audit committee member must have sufficient assertiveness, time availability, knowledge and experience to know what she or he is doing, to ask necessary questions, to make decisions, and to oversee the outside auditor and all of the people listed above who are involved in the accounting and financial statement function. This also requires that an audit committee member has to understand the services that are supposed to be performed by the outside auditor, and that are being performed, and be qualified to discuss those matters with the outside auditor in addition to the communications that the outside auditor is required to have with the audit committee and its members.

You should also refer to my separate audit committee self-evaluation paper and form.

Outside Auditor Communications with the Board or Audit Committee

It is beyond the purpose and scope of this paper to discuss the communications that the outside auditor is required to have with the board or audit committee or tasks that the outside auditor is required to perform. Most of the following topics that the outside auditor may or should discuss with the board or audit committee arise from Statements on Auditing Standards, which tend to be detailed or complicated and change over time. Accordingly, the following is a summary of discussions that the outside auditor should consider and in appropriate circumstances have with the board and/or audit committee.

-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 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, material deficiencies or errors, 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.

-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.

-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.

-The outside auditor must ask management about knowledge or allegations of any fraud or suspected fraud; 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, and 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 outside auditor also must inquire of the audit committee or the audit committee chair regarding the committee's views about the risks of fraud, the committee's oversight of the entity's assessment of the risks of fraud, the programs and controls the entity has established to mitigate those risks, and whether the committee has any knowledge of any fraud or suspected fraud.

-The outside auditor to obtain an understanding of the entity and its environment, including its internal control, 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 further audit procedures. The auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

-The industry, regulatory, and other external factors;

-The nature of the entity;

-Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements;

-The measurement and review of the entity's financial performance; and

-Internal control, which includes the selection and application of accounting policies.

With respect to the relevant industry, regulatory and other factors, the outside auditor should obtain an understanding of factors that include, for example, industry conditions, such as the competitive environment, supplier and customer relationships, and technological developments; the regulatory environment encompassing, among other matters, relevant accounting pronouncements, the legal and political environment, and environmental requirements affecting the industry and the entity; and other external factors, such as general economic conditions.

In pertinent part, with respect to the entity, the outside auditor is required to obtain an understanding of the components of internal control. See COSO 2013.

Regarding "control environment," the control environment sets the tone of the organization. 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.

In understanding the control environment, the auditor should consider such matters as the independence of the directors and their ability to evaluate the actions of management. The auditor also should consider whether there is a group of those charged with governance that understands the entity's business transactions and evaluates whether the financial statements are presented fairly in conformity with generally accepted accounting principles.

With respect to evaluating the participation of those charged with governance the auditor should consider: (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. 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.

-The outside auditor must communicate in writing to management and the audit committee (and perhaps the board) significant control deficiencies and material weaknesses in controls identified during the audit. The auditor's responsibility to communicate significant deficiencies and material weaknesses exists even if management or those charged with governance decided to accept that degree of risk.

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

See also, for example, COSO 2013, and statements on auditing standards 54 (fraud), 65 (consideration of the internal audit function), 78 (consideration of internal control), 83 (establishing an understanding with the client), 85 (management representations), 90 (audit committee communications), 98 (omnibus statement on auditing standards), 99 (consideration of fraud), 100 (interim financial information), 101 (auditing fair value measurements and disclosures), 107 (audit risk and materiality), 109 (understanding the entity and its environment and assessing risks of material misstatement), 110 (performing audit procedures in response to assessed risks), 113 (omnibus 2006), 61/114 (auditor's communications with audit committees and those charged with governance), 115 (communicating internal control matters identified in an audit, is applicable for all audits and is not limited to audits performed for the purpose of Sarbanes-Oxley §404), 116 (interim financial information), 117 (compliance audits), , 118 (other information in documents containing audited financial statements), 119 (supplementary information in relation to the financial statements as a whole), 120 (required supplementary information), 121 (revised SAS 100 interim financial information), 123 (omnibus statement), 125 (restricting auditor's written communications), 126 (ability of an entity to continue as a going concern), and 127 (omnibus statement).

5. <u>Annual Self-Evaluation, Board and Committees</u>

Should the board and its committees have or perform an annual self-evaluation? The short answer, yes. It is good for the members to consider the positive aspects of the board's activities and processes, and possible improvements including additional or different information, processes and education that might be helpful to the board members. No particular self-evaluation process is required. You can find both board and audit committee self-evaluation materials in my other writings. I also recommend that you use an outside facilitator to help with your evaluation process – although self-evaluation without a facilitator can be beneficial, as you can probably imagine evaluation without a facilitator it is likely to be less productive.

I hope you found this information helpful and useful to prompt discussions about these topics. Additional materials on many of these topics are available, and you can refer to my blogs. Please pass these materials to other people who would be interested.

David W. Tate, Esq.

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