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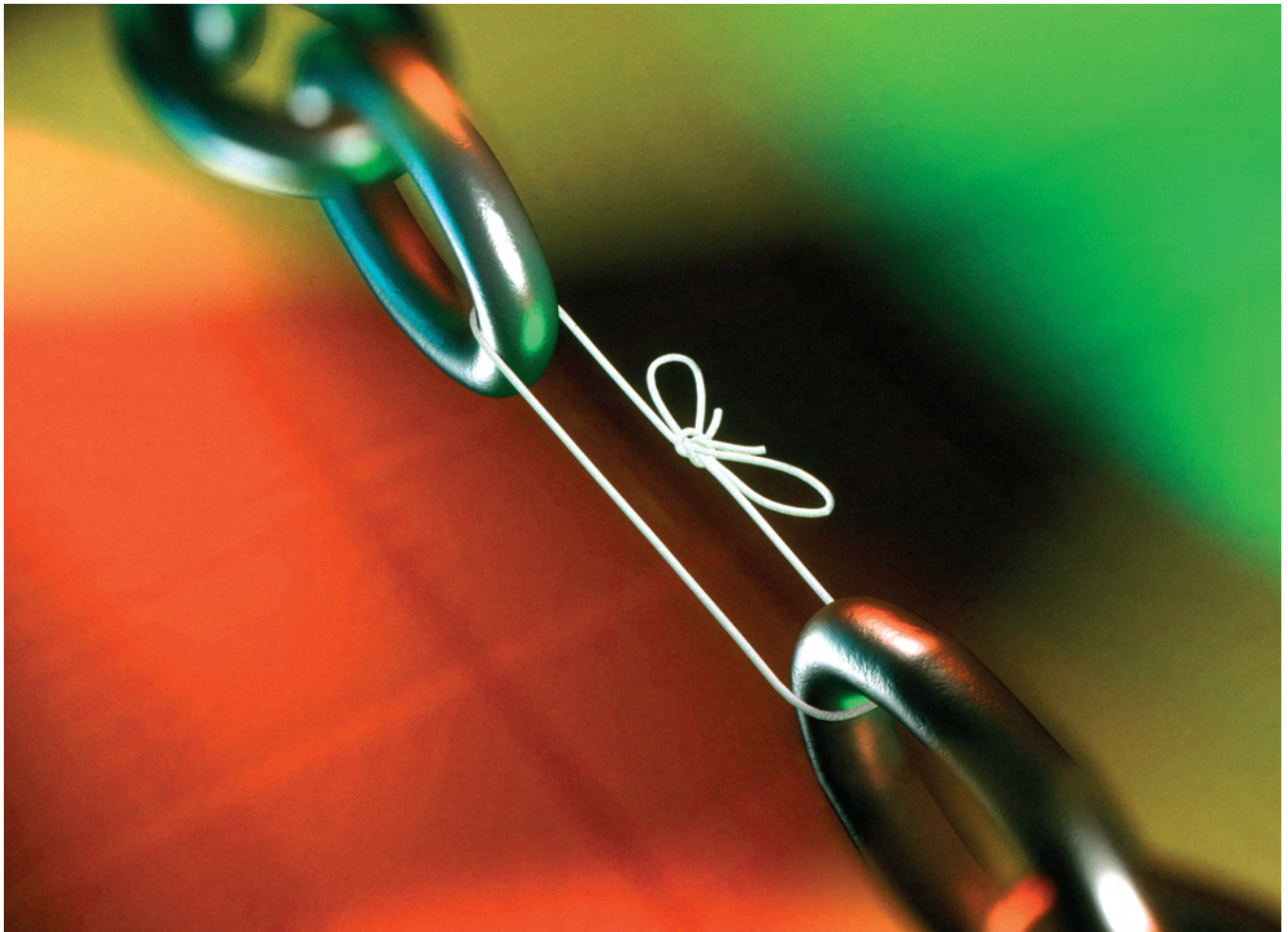
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# Audit Committee Material Weaknesses in Smaller Reporting Companies

By Audrey A. Gramling, Dana R. Hermanson, and Heather M. Hermanson

**O**ne of the critical elements of internal control over financial reporting is an effectively functioning audit committee. The Sarbanes-Oxley Act of 2002 (SOX) defines an audit committee as “a committee (or equivalent body) established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer.” In a December 2000 speech at the Federal Reserve Bank of New York, former SEC Chairman Arthur Levitt described an effective audit committee as “one of the most reliable guardians of the public interest.”

According to recent research by Jeffrey R. Cohen, Ganesh Krishnamoorthy, and Arnold Wright (“Corporate Governance in the Post Sarbanes-Oxley Era: Auditor Experiences,” June 5, 2009, [ssrn.com/abstract=1014029](http://ssrn.com/abstract=1014029)), audit committee effectiveness has improved following the implementation of SOX, particularly in terms of financial expertise and power. Recent SOX section 404 filings by smaller reporting companies (“nonaccelerated filers,” or registrants with less than \$75 million of public float), however, indicate that some small companies still are struggling to develop effective audit committees. Examining the disclosures made by smaller reporting companies and then analyzing the available

resources can be useful for small businesses seeking to establish and maintain effective audit committees.

### Section 404 for Smaller Companies

The SEC's rules require public companies to issue an annual report on the company's internal control over financial reporting and to include an auditor's opinion on their effectiveness. Most U.S. companies use the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) *Internal Control—Integrated Framework* as the benchmark for assessing the effectiveness of their internal controls, including their audit committee.

Smaller reporting companies have had an extended period of time before being required to comply with SOX section 404. After several delays, nonaccelerated filers provided their first management assessments of internal control over financial reporting in the annual reports for fiscal years ending on or after December 15, 2007. A separate auditor's report on internal control is required in the annual report for fiscal years ending on or after June 15, 2010.

### Sample Companies

In early June 2009, the authors used the Audit Analytics database to identify smaller U.S.-based public companies (market capitalization less than \$75 million), with management reports on internal control indicating material weaknesses related to audit committees for fiscal year 2008. Of the 2,850 companies that had filed management reports on internal control, approximately 600 disclosed material weaknesses in internal control. Of these 600 companies, 117 indicated that they had a material weakness related to the audit committee.

*Exhibit 1* provides descriptive information about the 117 sample companies. The companies are quite small, with median market capitalization of \$3.4 million, revenues of \$133,000, and assets of \$585,000. The median company had a net loss of \$681,000 in 2008, indicating significant financial distress.

The companies represent a broad range of industries, with the greatest concentrations in manufacturing; agriculture, mining, and construction; and services. The companies typically have other material weaknesses in addition to audit commit-

tee weaknesses. The median number of material weaknesses disclosed was three, with a range from one to 10.

### Audit Committee Material Weaknesses

The authors read management's report on internal control over financial reporting for each of the 117 companies to determine the nature of the audit committee-related material weaknesses. The authors also noted that the disclosures were quite uneven in their length and specificity, and, in many cases, professional judgment was needed to categorize the weaknesses. The most common weaknesses are presented in *Exhibit 2*.

The most cited issue is a simple lack of an audit committee or the lack of a functioning audit committee (78 companies). In a small number of instances, management explained that the company was a shell or startup enterprise or that the company had only one director or few employees.

It is important to note that SOX section 205 indicates that the full board may serve as the audit committee if a separate audit committee does not exist. Nevertheless, SOX section 301 generally requires that all audit committee members be independent directors. Thus, a full board serving as the audit committee presumably would need to be composed solely of independent directors. Completely independent full boards are rare, and, in these sample companies, the lack of a separate audit committee was determined to be a material weakness in internal control. In addition, the 2004 "Report of the NACD Blue Ribbon Commission on Audit Committees" states, "The board of directors and top management of any organization, regardless of size, must be fully committed to the goal of building and maintaining an effective audit committee." This would appear to indicate that the National Association of Corporate Directors (NACD) commission does not favor having the full board serve as the audit committee. The authors assert that all public companies should have separate, independent audit committees.

In 61 cases, management discussed the company's lack of independent (or outside) board members or audit committee members. To provide arm's-length oversight and comply with regulations, it is critical that

audit committee members be independent of management. In many cases, lack of director independence appeared to be a reason for failing to have an audit committee, while, in other cases, it appeared that the company had an audit committee, but one with nonindependent members.

In 34 cases, the disclosures related to the lack of board members with financial expertise. In some cases, lack of financial expertise appeared to be a reason for failing to have an audit committee, while in other instances, it appeared that the company had an audit committee with limited financial expertise.

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**The vast majority of the weaknesses identified appear to be foundational issues rather than weaknesses in specific audit committee processes.**

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Finally, six disclosures related to weak board oversight (not specifically mentioning the audit committee) and two described deficient or inactive audit committees. Entity-level control weaknesses, the lack of an independent audit committee chair, and the remediation of prior-year audit committee weaknesses were each discussed in one disclosure.

The weaknesses summarized in *Exhibit 2* primarily relate to the existence or composition of an audit committee—establishing the body and recruiting independent financial experts. Thus, the vast majority of the weaknesses identified appear to be foundational issues rather than weaknesses in specific audit committee processes.

### Improving Audit Committees

The authors' analysis provides insights into the extent and types of material

**EXHIBIT 1**  
Smaller Reporting Companies with  
Material Weaknesses Related to Audit Committees

Company Size	Median
Market Value	\$3,436,000
Revenues (43 companies had \$0 revenues)	\$133,000
Assets	\$585,000
Net Income	-\$681,000
Standard Industrial Classification Codes	
	Companies
0000-1999 Agriculture, Mining, and Construction	28
2000-3999 Manufacturing	40
4000-4999 Transportation and Communication	8
5000-5999 Wholesale and Retail	5
6000-6999 Financial, Insurance, and Real Estate	9
7000-8999 Services	27
Total	117
Total Number of Material Weaknesses	
Median number of material weaknesses per company	3
Range of material weaknesses per company	1–10

**EXHIBIT 2**  
Summary of Weaknesses Related to Audit Committees

Companies	Material Weakness
78	No audit committee; no functioning audit committee
61	Lack of independent board or audit committee members
34	Lack of financial experts to serve on the audit committee
6	Weaknesses in board of directors' oversight
2	Deficient or inactive audit committee
1	Weaknesses in entity-level controls
1	Lack of independent audit committee chair
1	Remediation of prior-year audit committee weaknesses

Note: Number of material weaknesses exceeds the 117 companies surveyed because some companies reported more than one weakness.

weaknesses related to audit committees that have been reported by smaller reporting companies. The findings indicate that some smaller companies are having difficulty establishing effective audit committees.

As these companies work on improving their audit committees, the authors encourage readers to consult the “21st Century Audit Committee Principles” listed in *Exhibit 3* for a broad perspective of audit committee best practices. Among the issues addressed by the principles are audit committee member independence and financial expertise, audit committee responsibilities, philosophy and culture issues, and risk assessment. The principles may be most helpful once a company has identified independent financial experts to serve on the audit committee, and the principles should be supplemented with more specific guidance.

In addition to the principles, the authors encourage readers to consult the sources listed in *Exhibit 4*, which offer a variety of specific insights into audit committee effectiveness. Several of these publications offer guidance that is especially well suited to smaller companies. Some insights from a few of these sources are highlighted below. The focus on getting the right people on the audit committee, setting up the right committee processes, and staying current on emerging issues is consistent with the NACD Blue Ribbon Commission’s approach to the issue of audit committee effectiveness.

**Finding the right people.** As revealed by the analysis of audit committee material weaknesses, smaller, less complex companies can face significant challenges recruiting and retaining qualified audit committee members. According to COSO’s *Internal Control over Financial Reporting—Guidance for Smaller Public Companies*, to aid in the search process, smaller companies may consider contacting organizations that maintain databases of potential audit committee members. For example, the following online resources may be helpful in the search process:

- AICPA—[www.aicpa.org/info/committees/index.asp](http://www.aicpa.org/info/committees/index.asp)
- FEI—[www.financialexecutives.org/eWeb/Dynamicpage.aspx?site=\\_fei&webcode=car\\_about\\_dr](http://www.financialexecutives.org/eWeb/Dynamicpage.aspx?site=_fei&webcode=car_about_dr)
- NACD—[www.nacdonline.org/registry/default.asp](http://www.nacdonline.org/registry/default.asp)



### EXHIBIT 3

#### 21st Century Audit Committee Principles for U.S. Public Companies

**1. Committee Purpose:** The purpose of the audit committee is to oversee all aspects of the financial reporting process, including preparation and filing of financial statements, internal control over financial reporting, and related risks.

**2. Committee Responsibilities:** The audit committee's major areas of responsibility include: 1) oversight of the internal control system; 2) oversight of the internal audit function and external auditor; 3) review of financial filings; and 4) establishment and oversight of a "whistleblower" process.

**3. Interaction:** Audit committee effectiveness requires ongoing, timely, and substantive interaction among the board, management, the external auditor, the internal auditor, and legal counsel.

**4. Independence:** The audit committee should be composed of independent directors only, and these directors should be chosen by an independent nominating committee. The CEO's role in selecting new directors, especially those who are targeted for audit committee service, should be limited.

**5. Expertise and Integrity:** The audit committee should have at least one financial expert, and all other members should have a high level of financial literacy. The financial expert should have a background in accounting, and there should be increased proxy disclosure as to the nature and timing of this accounting background. The committee members should reflect a mix of backgrounds and perspectives, and each member should be familiar with the company's risks and controls and capable of inquisitive and independent judgment. All members should receive detailed orientation and continuing education on financial accounting and reporting issues to ensure they achieve and maintain the necessary level of expertise.

**6. Philosophy and Culture:** The audit committee should clearly set expectations that financial statements and supporting disclosures reflect economic substance and that they be prepared in a manner that is informative and transparent. A legalistic view of accounting and auditing (e.g., "Can we get away with recording it this way?") is not appropriate. Management integrity and a strong control environment are critical to reliable financial reporting.

**7. Internal Control:** The audit committee is responsible for ensuring that management designs and implements sound internal control, which is essential for reliable financial reporting for any organization. SOX section 404 should apply to all public companies, and the primary focus of reporting on internal control should be effectiveness.

**8. Risk Assessment:** The audit committee should lead the board's assessment of enterprise risk, including the risk of management override of internal control. The board should also discuss the audit committee's fraud risk assessments and the fraud risk assessments developed by internal and external auditors.

**9. Meetings and Information:** The audit committee members should meet frequently for extended periods of time and should have unrestricted access to the information and personnel they need to perform their duties. Face-to-face meetings should occur at least quarterly, and executive sessions should be held at each

of these meetings. Additionally, the committee should meet in separate executive sessions with management, the external auditor, the internal auditor, legal counsel, and other advisors.

**10. External Auditor:** The audit committee should hire, evaluate, fire (if appropriate), and determine the fee of the external auditor with only minimal input from senior management. The committee should review the proposed audit scope and approach, as well as the external auditor's independence. Additionally, the committee should seek audit firms whose personnel are selected, evaluated, compensated, and promoted primarily on the basis of technical competence, not on their ability to generate new business.

**11. Internal Audit:** The chief (internal) audit executive should have direct reporting access to the audit committee, and the committee should oversee the activities and budget of the internal audit function.

**12. Oversight of "Whistleblower" Procedures:** Whistleblower allegations should be initially screened by an internal auditor or an external whistleblower system provider and reported directly to the audit committee. Access to the whistleblower process should be extended to outside parties (e.g., customers, suppliers).

**13. Compensation and Stock Ownership:** The board should consider any risks of audit committee member stock/stock option holdings and should set compensation at a level that is appropriate for the expanded duties and risks these members face.

**14. Service and Term Limits:** The board should limit the number of other audit committees on which its audit committee members can sit to no more than one other public company if the member holds a full-time position (three others for members who are retired). The board should consider limiting the number of years an individual can serve on the audit committee to ensure adequate rotation of its members.

**15. Disclosure:** In addition to disclosure of the audit committee responsibilities in the charter, the annual proxy statement should contain an audit committee report on actual activities performed. The audit committee should disclose the processes it uses in discharging its responsibilities, including: 1) the length of its meetings; 2) meeting participants; 3) use of executive sessions; 4) how the committee selects, compensates, and oversees the external auditor; 5) how the committee oversees the internal audit function; 6) the committee's role in overseeing internal control; 7) committee activities performed to assess the risk of fraudulent financial reporting, especially via management override of internal control and; 8) activities performed by the committee to review financial filings before their release to the public.

**Source:** Paul D. Lapedes, Mark S. Beasley, Joseph V. Carcello, F. Todd DeZoort, Dana R. Hermanson, Terry L. Neal, and James G. Tompkins, "21st Century Governance and Audit Committee Principles for U.S. Public Companies," May 8, 2007 ([www.kennesaw.edu/cgc/21stcentury\\_2007.pdf](http://www.kennesaw.edu/cgc/21stcentury_2007.pdf)).

## EXHIBIT 4

### Selected Sources of Information on Building Effective Audit Committees

- New York Stock Exchange and National Association of Securities Dealers, "Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees," 1999 ([www.kpmg.com/aci/other.asp#Blue](http://www.kpmg.com/aci/other.asp#Blue)).
- National Association of Corporate Directors, "Report of the NACD Blue Ribbon Commission on Audit Committees," 2000 (updated in 2004; [www.nacdonline.org](http://www.nacdonline.org)).
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- Keinath, Annemarie K., and Judith C. Walo, "Audit Committee Responsibilities," *The CPA Journal*, November 2004.
- American Institute of Certified Public Accountants, *Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention*, 2005 ([www.aicpa.org/audcommctr/download/achilles\\_heel.pdf](http://www.aicpa.org/audcommctr/download/achilles_heel.pdf)).
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- Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Internal Control over Financial Reporting—Guidance for Smaller Public Companies*, 2006 ([www.coso.org/documents/SB\\_Executive\\_Summary.pdf](http://www.coso.org/documents/SB_Executive_Summary.pdf)).
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- Keinath, Annemarie K., and Judith C. Walo, "Audit Committee Responsibilities Disclosed Since Sarbanes-Oxley," *The CPA Journal*, June 2008.
- KPMG Audit Committee Institute, "Ten To-Dos for Audit Committees in 2009," 2008 ([www.kpmg.com/Global/IssuesAndInsights/ArticlesAndPublications/Pages/Audit-committees-2009-top-ten.aspx](http://www.kpmg.com/Global/IssuesAndInsights/ArticlesAndPublications/Pages/Audit-committees-2009-top-ten.aspx)).
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- Beasley, Mark S., Joseph V. Carcello, Dana R. Hermanson, and Terry L. Neal, "The Audit Committee Oversight Process," *Contemporary Accounting Research*, vol. 26, no. 1, 2009.
- KPMG Audit Committee Institute, "The Audit Committee Journey: Recalibrating for the 'New Normal,'" 2009 Public Company Audit Committee Member Survey ([www.kpmg.com/Global/IssuesAndInsights/ArticlesAndPublications/Pages/Survey-finds-audit-committees-focused-financial-crisis.aspx](http://www.kpmg.com/Global/IssuesAndInsights/ArticlesAndPublications/Pages/Survey-finds-audit-committees-focused-financial-crisis.aspx)).

The search for the right people for audit committee service does not revolve solely around financial expertise and independence. As discussed in the *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, although financial expertise is an important requirement of audit committee members, audit committee members must also have the willingness and ability to ask tough questions. This suggests that effective audit committee members need to possess intelligence, diligence, and an inquisitive mind-set. Each of these factors should be carefully evaluated in the search process.

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*Developing the audit committee process.* An appropriately staffed audit committee also needs an appropriate structure and process. Audit committee practices will vary across companies according to their specific facts and circumstances, and the principles discussed above outline certain elements of an effective audit committee process. The starting point for an audit committee's process is its charter, which identifies the scope of the committee's responsibilities. The charter should clearly and concisely establish the framework for the audit committee's activities. The AICPA's Audit Committee Charter Toolkit ([www.aicpa.org/audcommctr/toolkitsnp/Consolidated\\_Matrix.htm](http://www.aicpa.org/audcommctr/toolkitsnp/Consolidated_Matrix.htm)) is an example of an online tool that can assist in charter development.

In addition, as emphasized by the NACD's Blue Ribbon Commission on Audit Committees, audit committees should meet as needed, with sufficient time allocated to the discussion of key risk areas

and how those risks are mitigated. In terms of evaluating and monitoring risks, the audit committee should consider information provided by its whistleblower program and by the internal and external auditors. As the NACD commission emphasizes, the audit committee's focus should be on risk—identifying and controlling key financial reporting risks.

Perhaps the greatest risk the audit committee faces is management override of internal controls. Management designs and implements controls and, therefore, is in a position to circumvent those same controls. The AICPA's *Management Override of Internal Controls: The Achilles' Heel of Fraud Prevention* ([www.aicpa.org/audcommctr/download/achilles\\_heel.pdf](http://www.aicpa.org/audcommctr/download/achilles_heel.pdf)) offers process-oriented guidance for audit committee members to consider. Important considerations include brainstorming about fraud risks and developing broad information networks throughout the company, rather than just communicating with the CFO and controller.

**Staying current.** Once an audit committee is established with the right people and processes, it is imperative that its members stay current on recent and emerging developments in business, accounting, and auditing. Continuing education for audit committee members is key. For example, audit committees should consider how their oversight has changed—or should change—as a result of the current financial crisis. How is the audit committee monitoring the resulting planned and unplanned changes? How are these changes impacting the company's financial reporting and internal controls? A recent KPMG report, "The Audit Committee Journey: Recalibrating for the 'New Normal'" ([www.kpmg.com/SiteCollectionDocuments/Audit-committee-journey-2009-member-survey.pdf](http://www.kpmg.com/SiteCollectionDocuments/Audit-committee-journey-2009-member-survey.pdf)), notes that the number one priority in 2009 for audit committees is understanding and monitoring the effect of the financial crisis on their company.

Looking forward, audit committees need to be ready to deal with International Financial Reporting Standards (IFRS), Extensible Business Reporting Language (XBRL), and a host of other potential changes. Following the passage of SOX, audit committees have increased responsibilities for ensuring that their external audit

firms comply with the auditor independence rules. To assist audit committees in meeting their enhanced responsibilities, the SEC has issued additional guidance, "Audit Committees and Auditor Independence" ([www.sec.gov/info/accountants/audit042707.pdf](http://www.sec.gov/info/accountants/audit042707.pdf)), that provides useful reading for audit committee members. Finally, smaller reporting companies' audit committees should be carefully monitoring the SOX section 404 process as their external auditors begin to issue their first internal control audit opinions in 2010.

### Importance of Leadership

The authors' analysis highlights that some smaller reporting companies are struggling to establish effective audit committees—often at the fundamental level of successfully establishing an audit committee with the right people and process. Once the audit committee is created, staffed, and working smoothly, perhaps the greatest focus of an audit committee should be on the tone at the top of the company. In "Ten To-Dos for Audit Committees

in 2009" ([www.kpmg.com/Global/IssuesAndInsights/ArticlesAndPublications/Pages/Audit-committees-2009-top-ten.aspx](http://www.kpmg.com/Global/IssuesAndInsights/ArticlesAndPublications/Pages/Audit-committees-2009-top-ten.aspx)), the KPMG analysis asserts that "in this environment, it is more important than ever to be acutely sensitive to the tone from—and the example set by—leadership, and to reinforce a culture of compliance and a commitment to financial reporting integrity throughout the organization." The authors believe that this is the central function of the audit committee, and all audit committees should be squarely focused on the company's tone. □

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