Audit Committee

Phil Kenkel
Bill Fitzwater Endowed Cooperative Chair

Oklahoma Cooperative Extension Fact Sheets are also available on our website at: **http://osufacts.okstate.edu**

The Audit

Most cooperative bylaws specify that the organization will hire an outside auditor to conduct an annual audit. The audit helps to prevent deliberate misstatement of fact. It also assures that judgment decisions are not duly biased in favor of management and to assure records are dependable. The audit also assures that generally accepted accounting principles have been consistently followed and that the disclosure is complete.

The audit is a key aspect of the board's fiduciary responsibility and part of the cooperative's internal controls. The audit does not shift the responsibility for the financial statements of the cooperative onto the auditor. The board retains the responsibility for the accounting system regardless of the method used to perform the audit. Because of the on-going responsibilities surrounding the audit, many cooperatives form audit committees within the board.

Why Form an Audit Committee?

The Sarbanes Oxley Act of 2002 mandated that firms which issue publicly traded securities must have a formal audit committee. The Act also included requirements for the composition and functioning of the audit committee. Although the Sarbanes Oxley Act does not apply to most cooperatives, this increased focus on the board's role with respect to the audit has encouraged cooperatives to evaluate forming an audit committee or to re-evaluate how their current audit committee is functioning.

The basic advantages to forming an audit committee are:

- It highlights the cooperative's commitment to its trustee responsibilities;
- It identifies and involves board members with financial competencies; and
- It provides a mechanism for year-around activities and oversight.

Who is the Audit Committee

Generally two to four members are picked from the Cooperative Board of Directors. They should be chosen for their skills in financial accounting, auditing, risk assessment, security, and internal controls. They should also be trustworthy and reliable.

The Entire Board as the Audit Committee

For some small cooperative boards, it may be more functional for the entire board of directors to serve as the audit committee. A small board (five to seven members) may find it is practical for the entire board to be involved in the audit functions. The disadvantage of this approach is that year-around audit responsibilities may be overshadowed by other issues. It is also important for the board/audit committee to distinguish between general board of director meetings and meetings to discuss audit related activities. Preferably, meetings or portions of meetings dedicated to audit committee functions should have their own minutes and agenda. Otherwise, it will be difficult to document that audit functions were carried out.

The Audit Committee Charter

The audit committee charter should set out guidelines for the duties of the audit committee versus those of the full board. It should be reviewed at least on an annual basis. By elaborating on the basic duties of the audit committee, the charter serves to help both the full board and committee members understand their obligations and the general boundaries in which they will operate and will ensure compliance with new legal and exchange requirements.

Membership

Recent regulations on corporate governance specify that audit committee members should be independent, that is, they should not be receiving any consulting fees or be involved with corporate subsidiaries. These independence issues are generally not present in cooperatives. Any member of the cooperative board would generally be eligible to serve on the audit committee. Because of the increasing emphasis on the audit committee's oversight of internal controls, many cooperatives are adding the financial manager or bookkeeper to the audit committee.

Financial Experts and Financial Literacy on the Audit Committee

Standards for publicly traded corporations require that at least one audit committee member has substantial financial and accounting knowledge. Most small agricultural cooperatives do not have a board member who meets all of the criteria of a financial expert. Every cooperative should attempt to identify an audit committee member who has the following abilities:

- An understanding of cooperative financial statements and generally accepted accounting principles;
- An ability to assess the general application of such principles in connection with the accounting for estimates

accruals, and reserves;
- Experience analyzing or evaluating cooperative financial statements that present a breadth and level of complexity of accounting issues;
- An understanding of internal controls and procedures for financial reporting; and
- An understanding of audit committee functions.

Audit committee members should consider attending additional training to improve their financial expertise.

General Fiduciary Responsibilities of the Board

The board of directors is charged with the responsibility to manage the business and affairs of the company. In discharging their responsibility, directors are subject to fiduciary duties to act in the best interests of the company and its stockholders. These fiduciary duties include the duties of care and loyalty.

The duty of care requires that directors inform themselves of all material information reasonably available to them, including possible alternatives, before making a business decision, then acting with requisite care in carrying out that decision. In exercising their duty of care, directors are specifically permitted to rely in good faith on management and the advice of the company's outside advisors, auditors, and other experts.

In making business decisions, directors have the benefit of the business judgment rule, a presumption applied by the courts that they acted on an informed basis, in good faith, and in the honest belief that their action was in the best interest of the company.

Members of the audit committee are subject to the same duties of care and loyalty and are currently afforded the same protections of the business judgment rule as other directors. It is important, from a liability perspective, for audit committees to implement and follow effective oversight procedures that evidence the proper discharge of their duties. While the members of the audit committee, like other directors, are entitled to rely on management and the advice of the company's auditor and outside advisors, in the current environment they must take extra pains to establish that they have a reasonable basis for this reliance.

Specific Authority and Responsibility of the Audit Committee

The audit committee is attributed greater authority over and heightened responsibilities for oversight of the independent auditor and other forms of cooperative internal management responsibility. The audit committee is responsible for assisting the board's oversight of the integrity of the company's financial statements, the performance of the company's internal audit function, and the company's compliance with legal and regulatory requirements.

Relationship with Independent Auditor

The cooperative's audit committee is required to be directly responsible for the retention, compensation, and oversight of the independent auditor. These responsibilities may not be delegated to the board. The independent auditor must report directly to the audit committee and not the board of directors. The audit committee's oversight responsibilities include the power to terminate the independent auditor as well as the ultimate authority to approve all audit and non-audit engagement fees and terms. The audit committee is also responsible for the resolution of disagreements between the management and the independent auditors regarding financial reporting. The audit committee must evaluate the qualifications, performance, and independence of independent auditor and the issuer.

How the Audit Committee Functions

A good understanding of how an audit committee should work is critical to the financial professionals who are part of the cooperative's internal and external audit teams. An audit committee must have four important concerns:

1. selection of the auditor;
2. determining the scope of the audit;
3. exercising diligence; and
4. ability to ask the hard questions.

Selecting the outside auditor is one of most important jobs of the audit committee. The more training and experience the auditor has with similar cooperative businesses the more familiar they will be with the special rules and procedures that apply. When engaging a new auditor, the committee may want to ask for references and discuss the auditor's work with other cooperatives. In preparation for the audit, the auditor will prepare a contract called an "engagement letter" that will describe the responsibilities of the auditor, the audit committee and other cooperative employees. The committee should review the letter and resolve any questions prior to engagement.

Second, the audit committee must adopt an agenda so that it is in a position to find out what accounting issues are of concern to management and/ or the outside auditor.

Third, the audit committee agenda should include a procedure for the analysis of the internal audit and internal audit controls so it can judge the effectiveness of the internal audit staff.

Fourth, the agenda should include participation in defining the scope of the work that the outside auditors are to perform as a result of the assessment of the internal controls and internal audit.

Fifth, the agenda should cover the annual review of the management and corporate code of conduct, as well as a review of its charter.

Sixth, the agenda should cover procedures so that the audit committee can receive candid assessments of the competence of the issuers' financial professionals and necessary unrestricted access to management, the internal audit staff, the outside auditors, as well as outside consultants who furnish related services.

Perhaps the **most important function** is that the audit committee diligently discharges its function to ensure the integrity of the issuers' financial statements through perseverance, earnestness, attention to detail, and thoroughness. To do this, the audit committee should be proactive in analyzing information it receives from management and have a full understanding of the key accounting issues for that particular company.

Finally, audit committee members must devote sufficient time to obtain an adequate understanding of what the company's financial statements represent. Members of the audit committee must have enough interest and time to be in a position to consult with outside counsel and experts, if necessary. Tough questions should be asked to be able to assess whether or not the answers it receives make sense and are correct for that issuer. Merely meeting for two or three hours a year is insufficient.

What the Cooperative Audit Should Include

The cooperative audit should include a review of the balance sheet, income statement, and statement of cash flows. The underlying documents supporting the information is given in these financial statements, along with verification of accounts receivable and payable balances with cooperative customers, and a review of the inventory quality, quantity, valuation, records, and procedures. The auditor also will verify the existence of recorded securities and review justification for judgment decisions, estimates, and review minutes of the board of directors' meeting for policy changes and instructions to management.

Audit Committee vs. Effective Audit Committees

The Difference Counts

Members want effective control of finances. The higher the cash inflow, the greater the need for an effective audit committee. An effective audit committee is an essential tool in overseeing the financial health of a cooperative. Some areas of common audit committee oversight include:

- Key Areas of Business and Financial Risk
- Code of Ethics at the Top
- Internal Controls and Systems
- External Audit Activity and Relationships
- Periodic Financial Reporting
- Internal Audit Activity
- Key Personal Selection for Critical Financial/Control Positions
- Establish procedures for handling complaints or concerns regarding internal accounting controls, audit maters or questionable accounting practices.

This is just to a partial list of the audit committee oversights.

Expanded Role and Responsibilities — New Rules

Although it does not directly apply to cooperatives, the new Sarbanes-Oxley Act must be kept in mind and respected even in the non-corporate arena. The Sarbanes-Oxley Act contains a number of provisions affecting audit committees, including heightened independence standards for audit committee membership, audit oversight, audit committee financial experts, audit independence, and auditor communications with audit committees. Basically, it is important to understand that no audit committee member from the board of directors is to have any special business arrangements with the party under audit, or the cooperative. Before generating an audit committee, Sarbanes-Oxley should be comprehended and considered. For the full text of this act, refer to the web file http://cpcaf.aicpa.org/Resources/Sarbanes+Oxley/.

Summary

Today's business climate has put more emphasis on audit responsibilities. Many cooperatives are establishing audit committees in order to better fulfill these highly important duties. Annual audits of the cooperatives financial records are the responsibility of the board of directors. The Board acts as a trustee of the cooperatives assets and is responsible for safeguarding, auditing, and appraising the cooperatives financial resources. Whether the cooperative establishes a committee or use of the full board, audit responsibilities are a year-round job.

The Oklahoma Cooperative Extension Service

Bringing the University to You!

The Cooperative Extension Service is the largest, most successful informal educational organization in the world. It is a nationwide system funded and guided by a partnership of federal, state, and local governments that delivers information to help people help themselves through the land-grant university system.

Extension carries out programs in the broad categories of agriculture, natural resources and environment; family and consumer sciences; 4-H and other youth; and community resource development. Extension staff members live and work among the people they serve to help stimulate and educate Americans to plan ahead and cope with their problems.

Some characteristics of the Cooperative Extension system are:

- The federal, state, and local governments cooperatively share in its financial support and program direction.
- It is administered by the land-grant university as designated by the state legislature through an Extension director.
- Extension programs are nonpolitical, objective, and research-based information.
- It provides practical, problem-oriented education for people of all ages. It is designated to take the knowledge of the university to those persons who do not or cannot participate in the formal classroom instruction of the university.
- It utilizes research from university, government, and other sources to help people make their own decisions.
- More than a million volunteers help multiply the impact of the Extension professional staff.
- It dispenses no funds to the public.
- It is not a regulatory agency, but it does inform people of regulations and of their options in meeting them.
- Local programs are developed and carried out in full recognition of national problems and goals.
- The Extension staff educates people through personal contacts, meetings, demonstrations, and the mass media.
- Extension has the built-in flexibility to adjust its programs and subject matter to meet new needs. Activities shift from year to year as citizen groups and Extension workers close to the problems advise changes.

Issued in furtherance of Cooperative Extension work, acts of May 8 and June 30, 1914, in cooperation with the U.S. Department of Agriculture, Robert E. Whitson, Director of Cooperative Extension Service, Oklahoma State University, Stillwater, Oklahoma. This publication is printed and issued by Oklahoma State University as authorized by the Vice President, Dean, and Director of the Division of Agricultural Sciences and Natural Resources and has been prepared and distributed at a cost of 20 cents per copy. 0410 GH Revised.