



# **PART I: Audit Committee Administration**

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# Chapter 1

## Benefits of a Private Company Audit Committee

**Overview:** A rapidly evolving regulatory environment and rising expectations of stakeholders have caused many entities to reassess their internal control and risk management practices. While public companies have been most directly and visibly affected by this trend, other organizations—including governmental bodies, not-for-profits, and private companies—have also experienced the impact of the changing compliance culture.

One key area of focus for many organizations has been the establishment and strengthening of audit committees. A well-structured audit committee can be a significant factor in improving overall organizational governance. At the same time, different organizations have different needs and issues, so “one size fits all” approaches are seldom appropriate. While some parts of this chapter might not apply to specific companies due to size, the intention is to provide guidance for both large and small audit committees.

The purpose of this chapter is to discuss the reasons why a private company might consider establishing an audit committee. It is to be used by management and directors in assessing their business objectives and determining whether an audit committee might be right for their organization. However, this is not intended to be all-inclusive guidance, rather a best practice when forming and evaluating a private company audit committee.

The creation of an effective audit committee is one key way of enhancing organizational governance and oversight, and it can help reinforce the company’s commitment to developing the proper “tone at the top.” However, while audit committees are mandatory for public companies, they are optional for private companies. Likewise, the composition and charter of private company audit committees is subject to much more discretion than is the case for public companies. Thus, as a private company evaluates its governance practices, it is useful to consider the various ways in which an audit committee can be beneficial to the objectives of the organization. Many of these potential benefits are discussed in the following sections.

### Financial Benefits

A well-designed and properly functioning system of governance can play a key role in achieving the financial goals of the organization. While an audit committee may not have a significant direct impact on the revenues and expenses of the organization, it can nonetheless foster a culture of compliance and control that will create important collateral financial benefits for the organization. Such benefits can include the following:

- Better financial results:
  - Effective governance practices lead to a more effective internal control system that, when overseen by an audit committee, can help ensure more accurate financial information and reduce the likelihood of fraud.

- An audit committee provides an independent channel for raising and resolving key ethics, compliance, and financial reporting issues, thus helping to prevent or deter violation of corporate policies by employees or management.
- Sound governance practices can reduce the risks of the organization, resulting in lower insurance, legal, and borrowing costs.
- Prudent corporate governance can help create conditions that make the organization a more desirable business partner, leading to expanded opportunities for the business.
- Improved access to capital:
  - Just as investors and lenders have come to expect vigorous corporate governance practices in public companies, they are also beginning to have similar expectations for private companies.
  - Strong corporate governance enhances the intrinsic value of the entity by lowering the risks for potential acquirers and investors.
  - Governance and internal control practices similar to those required of public companies can make it easier for private companies to consider seeking capital in public markets.

## **Better Decision Making**

The establishment of an audit committee can contribute to better management decision making in a number of ways, as follows:

- Ensuring the accuracy of financial reports upon which decisions are based:
  - Through a focus on key risks and controls, an audit committee can help to ensure the accuracy, timeliness, and completeness of financial information necessary to manage the business.
  - An audit committee can also help to bring added clarity to the roles and responsibilities of the organization's employees, thereby increasing the likelihood that transactions will be properly executed and recorded.
- Enhancing the quality of decision-making processes:
  - An audit committee can bring a broader perspective to risk assessment and regulatory compliance matters.
  - An audit committee can help to ensure open communication between the board, management of the organization, and external and internal auditors.
  - By asking tough questions of top management, audit committee members can add rigor to the process of reaching key decisions.

## **Stronger Relationships With Stakeholders**

Private companies have many key stakeholders, including employees, customers, vendors, investors, lenders, regulators, and community members. Relationships with each of these constituents—both internal and external—can be enhanced by the presence of a properly functioning audit committee. This can occur in the following ways:

- Internal stakeholders:
  - An effective audit committee can help to set an appropriate “tone at the top” by promoting a culture of integrity and loyalty.
  - An audit committee represents the interests of all owners of the business, including not only the active owners but also minority owners, less involved family members, and the like.
- External stakeholders:
  - Strong corporate governance is consistent with a general societal trend toward enhanced independent oversight of business organizations.
  - An audit committee can instill confidence in business partners, potential investors, and others. It can also add further credibility to contractual relationships with vendors and customers.
  - Strong governance can lead to increased credibility with IRS, FDA, FTC, and other regulators.

### Other Benefits

In addition to the points discussed above, an audit committee can provide other benefits to a private company. These include the following:

- In situations in which private companies anticipate transitions in leadership—for example, in the case of a family-owned business—an audit committee can provide an important channel between the auditors, the current owners and managers, and passive owners. Similarly, an audit committee can help mitigate organizational conflict and provide continuity during the leadership transition.
- In situations in which private companies contemplate entering the public capital markets, a preexisting audit committee can help to facilitate the process and ease the transition to the requirements of Sarbanes-Oxley.

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