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Supporting the Audit Committee after Sarbanes-Oxley: A Practical Guide

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The Sarbanes-Oxley Act of 2002 (SOA) has resulted in sweeping changes in the governance of public companies whose securities are listed on US markets. The SOA, together with its implementing rules and the listing requirements adopted pursuant to it, has affected no aspect of corporate governance more than the audit committee. The sidebar accompanying this article titled, "New Duties for Audit Committees," summarizes the principal new duties imposed on audit committees. The changes call for the committee to perform new functions and to carry out old functions with a good deal more rigor. The effect is dramatic even for larger financial services companies, which have been subject to a similar but simpler regime since the adoption of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA).

The SOA went through Congress in near-record time. The Senate bill moved from introduction to passage in 21 days and the conference committee completed its work in 5 days. The SOA

called for the development of regulations and listing requirements on a comparably fast track, so that the various effective dates came upon companies very quickly. Perhaps for that reason, most of the articles dealing with the SOA and audit committees have focused on the daunting job of implementing its many requirements.

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The focus of this article is different. It assumes that the basic building blocks for a SOA-compliant audit committee are in place. The question addressed here

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is how management can support the audit committee in this dramatically different environment.

First, it is worth analyzing just what it is about the SOA that creates such a different environment around the audit committee.

New Relationships and New Risks

One effect of the SOA is altered relationships among the audit committee and its many constituencies. The audit committee now has essentially complete responsibility for the company's relationship with the independent auditors, which calls for significantly more communication between the committee and the independent auditors, without management functioning as a filter or even providing context. At the same time that management takes a reduced role in the company-auditor relationship, it is required to take on additional responsibilities to the audit committee and to discharge them in a setting that has significantly more definition and clarity.

In most publicly held companies of any size, internal audit has for some time played an important role in helping the audit committee discharge its oversight mission. The SOA makes this role unambiguous and direct. Because of the audit committee's new responsibilities and the way in which old responsibilities have been more sharply defined, the SOA and implementing rules may change the manner in which the audit committee relates to the full board of directors and even the way in which stockholders view the committee.

These changes are intended to improve corporate governance by increasing the levels of both transparency and oversight in the financial reporting of public companies. The ultimate goal is to avoid a repeat of the dismal succession of corporate scandals we have seen in the last few years. There is a good deal of promise in the changes that the statute has produced in the work of audit committees, but there are some dangers as well.

All of these new responsibilities mean an increased workload for directors serving on audit committees, multiplying the demands on members' time and undoubtedly causing some audit committee members

New Duties for Audit Committees

The SOA, the implementing rules of the SEC under it, and the new listing requirements of the self-regulatory organizations call for audit committees to take on a host of new duties and responsibilities. Among the key ones are these:

- Adopt a charter with specified content and review it periodically;
- Hire, fire, pay, and oversee the independent auditors;
- Preapprove audit and permissible nonaudit services provided by the independent auditors;
- Resolve disagreements between management and the independent auditors;
- Establish complaint procedures for accounting, internal accounting controls, and auditing matters;
- Establish hiring policies for employees or former employees of the independent auditors;
- Decide whether to engage independent counsel and other advisers;
- Review the independent auditors' internal quality control procedures, issues raised by internal reviews, peer reviews, inquiries or investigations, and relationships with the company;
- Discuss financial statements and related matters, including the following: (1) accounting principles and policies used and alternatives considered; (2) effectiveness of internal controls and internal controls issues; (3) any difficulties or disagreements in the audit process; and (4) Management's Discussion and Analysis;
- Discuss regulatory and compliance issues;
- Discuss management's approach to earnings releases and earnings guidance;
- Review risk-assessment and risk-management policies;
- Review and approve all related party transactions (required for Nasdaq companies); and
- Conduct annual performance evaluation of committee (required for NYSE companies).

to reconsider their willingness to serve. To the increased time demands is added increased concern about liability. Audit committee members are required to make and disclose many more judgments, sometimes in very difficult areas, than was previously the case. The standard of liability may not be different for audit committee members—the Securities and Exchange Commission (SEC) has even provided some protection for “audit committee financial experts” in Item 401(h)(4) of Regulation S-K—but the fact that there are more, and more visible, points at which liability will attach will certainly give some members pause. The tracks of the decisions that the SOA requires can be followed not only by investors making buy or sell decisions, but also by plaintiffs’ attorneys should things go wrong.

These detailed new requirements also create some risks to achieving the ideal governance model the SOA envisions. There is a very real danger that audit committees will become prisoners of compliance, drowning in the paper required to create the necessary record and wasting time on too many reports that are neither meaningful nor useful. The detail required also creates an invitation for an audit committee to micromanage the financial reporting process and, to some extent, even the audit process. Whatever the talents of the committee members and however diligently members prepare for periodic meetings, management tasks are best left to those who are familiar with the company’s business and look after it on a day-to-day basis.

These dangers and risks need to be addressed. It is management’s job to address them by working with the committee, the auditors, and other members of the cast to maximize the positive benefits of the SOA and to avoid or minimize the negatives. What follows is some very practical advice about what management can do to support the audit committee after the SOA.

Audit Committee Membership

The SOA mandates key attributes of the audit committee’s composition. Every member must be independent under definitions that significantly reduce the scope for subjective judgment about what that means and each committee must either have an “audit committee financial expert” or be prepared to disclose why it believes one is not necessary. Boards of directors have spent and will spend a good deal of time making sure

these criteria are met and documenting that they have been met.

Boards should think about some other aspects of audit committee composition in the post-SOA world, however. Because of the nature of the committee’s tasks, there is probably a greater need to select for collegiality than ever before. In addition to looking for teamwork skills in individual members, it is also important to balance or blend the individual talents of committee members in order to promote collegiality. Two CFOs on a three-member committee, for example, may be one CFO too many.

There is also a somewhat higher premium on courage, in at least two senses: (1) the courage to challenge meeting participants, such as the auditors, who have a high level of expertise but may sometimes confuse forests and trees; and (2) the courage to step up to the many new tasks and judgments that the SOA requires. It will be important to include on the committee one or more members who can help with context or perspective. In seeking an audit committee financial expert, for example, it might be a good idea to look for a present or former CFO who has had experience reporting to an audit committee and to prefer that candidate for this role over, for example, a professor of finance.

Pay should also be addressed. It is perfectly appropriate to recognize in director compensation the increased workload that audit committee members, and especially the chairperson, must now shoulder. Management can help the board reach an informed decision about how to do that by providing the relevant data.

Meeting Preparation

Most undergraduate or graduate school professors figure that an hour of classroom teaching requires three to five hours of preparation time. The multiplier for audit committee meetings is—and ought to be—considerably higher. Preparation will directly affect the quality of the meetings and the experience of all participants.

Premeeting materials. Committee members should receive as complete a set of materials for the meeting as is possible at least several days in advance. This avoids the deadly sort of meeting that transpires when directors are trying to absorb complex materials and ask intelligent ques-

tions about them at the same time. It also creates a record of thoughtful attention to the business of the committee.

Some documents stand on their own as part of the pre-meeting materials—an earnings release, the auditors’ annual presentation on independence, and the regular report of the internal audit department, for example. Other documents will be much easier for directors to absorb quickly if management prepares a “road map.” The committee will most likely review annual financial statements at the same meeting at which it reviews Management’s Discussion and Analysis and portions of the annual report on Form 10-K. A cover memorandum, in which the CFO or controller calls the committee’s attention to significant changes in disclosure or important judgments reflected in the drafts, or to other matters that the directors should note, will help the committee members focus their review and expedite discussion at the meeting.

For all reports to the committee, investing the time necessary to use a board-friendly format will also pay off in lightening the directors’ burden and improving the quality of the discussion. Financial statements must be delivered in whole, as must some other items, but any other material that can be presented in graphic form, through a chart or even an outline, will be much easier for directors to absorb quickly.

Planning the agenda. Close coordination with the chairperson of the committee is essential in preparing for a particular meeting and between meetings. The committee will want to meet often enough to discharge its responsibilities without packing any single agenda so that discussion is constrained. Four meetings a year are essential, and the committee will probably want a fifth and perhaps more to deal in greater depth with more complex subjects.

Consulting with the chairperson to allocate time to various subjects is also important. Once that is done, management should work with all participants to shape the presentations to the time allotted. The chairperson then can act as enforcer, keeping participants to their commitments and bending only to the extent necessary to allow full discussion by committee members.

It also helps to vary the pace and content of the meetings. A short meeting, for example, may be all that is necessary to review the earnings release for an unexpected quarter. The meeting to review the annual financial statements will be considerably longer.

Stepping through complex subjects, such as a substantive change to the audit committee charter or a

change in independent auditors, by covering the topic at more than one meeting makes good sense. Proposing a change at one meeting and acting on it at the next allows time for reflection between meetings and, importantly, allows off-line discussions among members and between management and particular members. This process helps avoid confrontation and increases the committee’s ability to reach agreement on difficult issues in a collegial manner.

Rely on other committees. Especially in financial institutions, other committees of the board of directors often have responsibilities that touch on matters central to the role of the audit committee. Although under the SOA the audit committee has significant responsibility for evaluating risk—some would say that risk evaluation is the heart of overseeing financial reporting—the audit committee can look to other committees to contribute. A board-level credit committee, for example, or a broader “business risk” committee can look at certain types of risk in more detail than is possible for the audit committee, and the audit committee can rely on the work of such committees. The commentary to New York Stock Exchange (NYSE) rule 303A(7)(c)(iii)(D) specifically notes that existing risk-management mechanisms must be reviewed by the audit committees, but need not be replaced by it.

Avoid information overload. This is a major risk and nothing will demoralize the audit committee members as quickly as the sense that they are being asked to wade through too much because participants are shirking their own responsibility to select and bring forward only the information and decisions that should rightly concern the audit committee. Management itself must use discipline and avoid the “when in doubt, put it in the package” syndrome. Management then needs to work with the chairperson and all meeting participants to develop the appropriate expectations and see that they are met. Because the direct reporting relationship between the audit committee and the independent auditors is now so clear, the chairperson has special responsibility for communicating expectations of this type directly to the auditors.

Master Calendar and Checklist

Every listed company should now have an audit committee charter that reflects the requirements of the SOA, the implementing rules, and the listing require-

ments that bear on the work of the audit committee. This can be an overwhelming document with a list of responsibilities and tasks that seems to go on forever. A director can rightly wonder whether the committee can actually do all this and, as the annual cycle rolls on, whether it is touching all the necessary bases.

The requirements of the charter, however, can be arrayed in a checklist of audit committee tasks, which can then be allocated to the meetings planned for a particular year. This will be useful to the chairperson, the other committee members, and the meeting participants as a planning device. It will, among other things, help show opportunities to combine subjects, rework the customary processes, and in other ways reduce the burdens of the committee—and perhaps even management.

More important, the calendar and checklist can be used as a simple way to show at each meeting—even better, with the premeeting materials—what has been covered already and what is to be covered at the current meeting, against what needs to be covered. This will shortcut a good deal of discussion and increase the committee's comfort that it is actually reaching all of the necessary items, allowing it to focus on each item more effectively. The calendar and checklist also create a clear and simple record of compliance. Finally, a calendar and checklist of annual items will also allow the committee to plan its longer-term agenda, setting aside time for issues that do not recur in any routine way but should be addressed.

Go Overboard—Selectively

Covering the matters now mandated by the SOA creates a very full agenda. Given the risks of information overload, one should think very carefully about adding an additional report or agenda item to an audit committee meeting.

The same principle does not apply to communicating with committee members, and especially the chairperson, about matters that affect the work of the committee. Frequent between-meeting contact with the chairperson makes sure that important developments are shared and demonstrates that management communicates those developments on a timely basis. No significant issue should be held for a first discussion at a meeting or even at the preparatory meeting with the chairperson if there is an appropriate opportunity to inform the chairperson in advance.

In a similar vein, the audit committee meeting schedule will require using cutoff dates for the information in formal reports furnished to the committee. A meeting in late April, for example, would typically cover information through March 31; a meeting in October would feature information through September 30. Those cutoff dates make perfect sense and help create a record that, in retrospect, is logical and complete.

Cutoff dates, however, should be ignored for matters that are significant. If, for example, there has been a significant credit or operational loss since the cutoff date for a particular meeting, but prior to the meeting itself, information about the loss should be shared with the committee to whatever extent is possible. Giving even a warning will avoid a surprise at the next meeting and allow a more complete and focused discussion of the event.

Thoughtful Participation by Management and Others

Various members of management will participate in audit committee meetings. The internal auditor has been and will continue to be a key participant in audit committee meetings. Under the listing requirements, a key purpose of the audit committee is to assist in board oversight of the internal auditor. The comprehensiveness of the internal audit program at most larger financial institutions means that internal audit will be an integral part of the control process and an important source of information and perspective for the audit committee.

The internal auditor trap. It is important to avoid the internal auditor trap, however. Because the scope of the function is so broad, and the report a necessary agenda item at each meeting, it is possible for the internal auditor's report to become the principal vehicle through which management speaks to the committee. Internal audit results, the status of management's implementation of internal-audit-approved "fixes," issues raised by the independent auditors and even the regulators, and management initiatives that may affect financial reporting—all can gradually find their way into the internal audit report. The internal auditor, especially if he or she is talented and hardworking, can become the principal spokesperson for management.

That's a mistake. The inevitable result is that the internal auditor becomes not just the conduit for information but the defender of what is being communicat-

ed—an advocate for management’s position on any issue that has found its way into the report. This undermines the internal auditor’s credibility with the audit committee and may even threaten his or her independence.

Involve management. To avoid this trap, involve relevant members of management in the process. The CFO, for example, should obviously present earnings releases and financial statements, but should also take the lead in reporting on new accounting pronouncements, significant write-offs or charges, changes in structure or business lines, and other matters that might affect financial reporting. The general counsel should cover legal and regulatory issues, and senior operating personnel should cover internal control issues affecting their areas, since it is with them that fundamental responsibility for those controls lies.

Economy and continuity. At the same time, it is important not to turn the audit committee meeting into a vaudeville routine with an ever-changing cast of characters. Management should practice economy and emphasize continuity in planning the meetings, so that committee members hear only from the senior people with responsibility in the area and from the same people from meeting to meeting. The committee will thus be able to understand more quickly the roles played in the company by those participating in the meeting and will have an opportunity to develop both confidence in them and a sense of what questions to ask. Audit committee meetings are not the platform for giving a succession of more junior personnel exposure to the board; there are other occasions for that.

Work with the auditors. Finally, it is important for management to coordinate as much as possible with the independent auditors. Their primary responsibility is to the audit committee, which is charged with the authority to hire and fire them, but that does not mean that the auditors’ communications with the audit committee must come as a surprise to management. Issues will be more fully communicated to and discussed by the committee if those with the most knowledgeable perspectives on the issues share their views in advance.

Use the committee’s leverage. In March 2004, the Public Company Accounting Oversight Board (PCAOB) adopted Auditing Standard No. 2, *An Audit of Internal Control over Financial Reporting Performed in Conjunction with an Audit of Financial Statements*; the SEC approved it in June. Among its many detailed provisions, it requires the independent auditor to assess on an annu-

al basis the effectiveness of the audit committee’s oversight of external financial reporting and internal control over financial reporting. The audit committee’s key role in the governance structure of a public company should be enough to motivate all participants to support the committee and furnish whatever it needs. The prospect of this annual report card, when a failing or even less than satisfactory grade will have dire consequences, creates a lever that the committee and management can use in particular cases when the more abstract motivation has not been sufficient.

Consider Training for Audit Committee Members

Most people join an audit committee with significant relevant experience—that’s the point of putting them on the audit committee. At least one member will typically be an “audit committee financial expert.” Some types of training, however, can help audit committee members do their job better, by making them more informed about the company and its particular issues or about matters bearing on their responsibilities generally. Training can also promote an informed and common view among committee members in areas important to their work. It certainly creates a record that will be useful in the event of any litigation challenging the manner in which the committee has discharged its duties.

One useful practice that can be characterized as training is the systematic orientation of new members. Especially after the SOA, it makes sense to think in a more organized way about how to introduce new members to their duties. A review of the audit committee charter, explaining how it came to include what it does and how the committee fulfills its duties under the charter, would be a good place to start. A similarly systematic review of financial statement or accounting issues peculiar to the financial services area would also be useful, since many members will come to the committee without significant experience in areas such as the reserve for credit losses or interest-rate-risk management. For the same reason, an organized review of the legal and regulatory environment of financial services would also be useful.

Education for the committee on a continuing basis might take the form of periodic reports on macrolevel developments affecting the work of the committee,

such as initiatives by the PCAOB or enforcement activities of the SEC. Case studies relevant to the financial services area would also be useful and likely of real interest to committee members—organized reviews of particular, widely reported situations in which things have gone wrong, with an emphasis on the role that the audit committee (or the board of directors) played, or did not play, as events unfolded.

There are any number of ways to come at this issue, including—especially for smaller organizations—sponsoring director attendance at programs focused on audit committee members. The main thing is to do something that the committee members of the particular organization find useful. Whatever is done should be documented, so that the record can be used in regulatory examinations, in helping inform the independent auditors' evaluation of the committee's effectiveness, and, if necessary, in litigation.

Facilitating Self-Evaluation

Only the NYSE requires that the audit committees of companies listed on that exchange conduct an annual self-assessment. There are obvious benefits to self-assessment, however, that should lead an audit committee to consider such a program even if the company's stock is not listed on the NYSE.

One useful practice that can be characterized as training is the systematic orientation of new members.

Self-assessment, if conducted in the right way, allows the committee to engage in continuous improvement, reflecting regularly on how it has conducted its business and finding ways to improve. Improvements, of course, do not always come in the form of additional tasks—sometimes they consist of discontinuing tasks that have not proved helpful or finding a more efficient way to conduct tasks that are helpful. In addition to creating a methodology for continuous improvement, self-assessment also creates a record of care and deliberation that can be important in the event of litigation.

There are some less obvious benefits, as well. If conducted appropriately—as an attempt to evaluate the performance of the committee and not of the individuals who sit on it—self-assessment can promote collegiality, as it creates a regular occasion for surfacing criticisms that otherwise may come out in less constructive ways. It can also cause individuals to rethink their own methods of participating in the committee and lead to improvements in that area without directly confronting individuals. Finally, a self-evaluation can inform and even help shape the independent auditors' annual evaluation of the committee's effectiveness under the PCAOB's Auditing Standard No. 2.

There are some risks. The usual concern is that the self-assessment, which may include the unvarnished views of committee members and others, may be discovered in litigation. That risk can be reduced in jurisdictions that recognize a self-evaluative privilege and protect from discovery at least the judgments that form a part of a thorough self-assessment. This privilege, however, is recognized only in some states and has not been well tested in this context.

It is also possible to mitigate the discovery risk by using counsel for the company or the audit committee to administer the self-assessment. The problem with this approach is that the attorney may be viewed as a mere conduit, and his or her participation may therefore prove insufficient to invoke the attorney-client privilege. Whether the privilege actually will apply in a particular situation will depend on the nuances of the applicable law, but the odds are increased if the attorney plays a key role in analyzing the views of committee members and other participants and communicating them to the committee, as well as a role in designing the questionnaire or other information-gathering tool.

One self-assessment protocol that can maximize the benefits of self-assessment while minimizing its risks is to ask counsel to develop a questionnaire that lists the principal functions of the committee. Members are asked to mark all those areas that they believe merit discussion with a view toward improvement and are invited to note any suggestions they have in those particular areas. The attorney compiles the results and then prepares an agenda for a meeting where the committee discusses those areas that have been identified for discussion. The minutes reflect the discussion and any changes in procedure agreed upon.

Some governance experts recommend the questionnaires then be discarded, pursuant to an undertaking to that effect made in advance for the purpose of encourag-

ing candid comments and discussion. If that is a feature of the program, care must be taken that the materials are retained if there is reason to believe they may be relevant to any government investigation or proceeding.

In any event, a process such as this should maximize the prospect that the attorney–client privilege attaches. Should it not attach in a particular case, the written materials will have been created with some care and with an emphasis on positive suggestions rather than bare criticisms.

Working with Independent Resources

The SOA and its implementing rules require that audit committees have the power to engage on their own initiative counsel independent of the company. This requirement has applied for some years to large banking organizations subject to 12 C.F.R. Part 363,

adopted pursuant to the FDICIA. There can be little doubt that independent counsel makes good sense when the committee is struggling with a serious financial reporting issue in which management’s interests—or even management’s conduct—may be at odds with the interests of the company. Is it a good idea in the usual case? That is, should every audit committee engage standing independent counsel, responsible only to it? Or is regular company counsel sufficiently except in unusual circumstances?

Having the audit committee engage its own independent counsel directly would, of course, increase both the appearance and the reality of audit committee independence. It would also mean that the audit committee has its own source of legal information and advice. This can be an advantage in cases when regular corporate counsel is strong on banking and regulatory issues, but not especially skilled in financial reporting, disclosure,

Laws and Rules Affecting Audit Committees

The following includes principal sections of the SOA and some other important rules and listing requirements that deal with audit committee responsibilities:

- Section 301 of the SOA [15 U.S.C. § 78f(m)] directs the SEC to adopt rules requiring self-regulatory organizations to prohibit the listing of the securities of companies not complying with the standards relating to audit committees outlined in the statute.
- Rule 10A-3 under the Securities Exchange Act of 1934 [17 C.F.R. § 240.10A-3] implements Section 301 of the SOA and covers the key areas to be dealt with in listing requirements.
- Section 303A, Subsections 6 and 7, of the *NYSE Listed Company Manual* were adopted and approved pursuant to SEC Rule 10A-3.
- Rule 4350(d) of the NASD Rules implements SEC Rule 10A-3 for Nasdaq companies.
- Sections 121 and 803 of the *American Stock Exchange Company Guide* implement SEC Rule 10A-3 on the Amex.
- Section 204 of the SOA [15 U.S.C. § 78j-1(k)] covers the communications required from the independent auditors to the audit committee and has been implemented by Rule 2-07 of Regulation S-X [17 C.F.R. § 210.2-07].
- Section 407 of the SOA [15 U.S.C. § 7265] requires the SEC to adopt rules requiring the issuer to disclose whether an audit committee includes among its members a “financial expert,” and Item 401(h) of Regulation S-K [17 C.F.R. § 229.401(h)] implements that requirement.
- Other disclosure rules relevant to audit committees are contained in Item 401(i) of Regulation S-K [17 C.F.R. § 229.401(i)] requiring identification of the audit committee, and Item 7 of Schedule 14A [17 C.F.R. § 240.14a-101], which requires disclosure about the composition, charter, and functioning of the audit committee.
- 12 C.F.R. Part 363 implements the section of the FDICIA [12 U.S.C. § 1831m] which requires certain financial institutions to have independent audits and audit committees.

or corporate governance issues. These benefits come with a price, however. Independent counsel will want to justify its role and this may result in the committee having to deal with issues that, although arguably real, are just not material.

One way to approach this question, for a company not in crisis, is to have management engage separate counsel, expert in the areas of concern to an audit committee, who will be dedicated to supporting the audit committee. This gives the committee its own source of expert advice. The nature of the engagement means that there is an incentive for management, audit committee counsel, and regular company counsel to work collaboratively in normal times, but the audit committee counsel's role and primary loyalty is clear in the event actual conflicts materialize. Counsel's work for the company should be restricted to supporting the audit committee, so that if the need arises a "sole reporting" line to the audit committee can be put in place without concern that other work interferes with counsel's independence.

Particular situations may arise when the committee or its counsel see a need to engage other independent resources to assist in resolving particular issues—a forensic accountant or a valuation specialist, for example. The

committee's authority to do so is quite clear under the SOA. Management would be well advised to anticipate the need for this kind of expertise and facilitate the committee's evaluation of the different potential sources of advice.

Conclusion

The SOA has meant a major change in how the audit committees of public companies function. (The sidebar titled, "Laws and Rules Affecting Audit Committees," lists the more important statutes and rules affecting audit committees.) The initial task of laying out in a charter all of the new responsibilities and functions is largely completed, but in some ways the hard work has just begun. A thorough, thoughtful approach by management to working with the committee to make the charter come alive can minimize the burdens of the SOA and maximize its benefits for all of the company's constituencies. The key change is an attitudinal one. Whatever one may think of these changes or particular aspects of them, they are the law. Management's best response is to understand them and help the audit committee find and hold the high ground.

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