MINUTES OF THE BOARD OF GOVERNORS OF
HIGHWATER ETHANOL, LLC
6/26, 2008

Pursuant to the call of the Chairman of the Board of Governors of Highwater Ethanol, LLC, an Minnesota limited liability company (the "Company"), and in accordance with the Company's Amended and Restated Member Control Agreement, a meeting of the Board of Governors of the Company was held on June 26, 2008. Brian Kletscher, George Goblish, David Moldan, Ron Jorgenson, Russ Derickson, Tim Vanderwal, Warren Pankonin, Mike Landuyt, Todd Rief, John Schueller, Jason Fink, were in attendance. Such meeting was properly and duly noticed and the number of Governors necessary to constitute a quorum pursuant to the Company's Amended and Restated Member Control Agreement was present. The follow Resolutions and Actions were duly adopted by the Governors at such meeting:

WHEREAS, the Board of Governors seeks to adopt a Code of Ethics for Chief Executive and Senior Financial Officers (the "Code of Ethics") (attached hereto as Exhibit A) in compliance with Security and Exchange Commission regulations;

WHEREAS, the Board of Governors seeks to adopt a Charter of the Audit Committee of the Board of Governors (the "Audit Committee Charter") (attached hereto as Exhibit B) in compliance with Security and Exchange Commission regulations;

WHEREAS, the Board seeks to appoint an Audit Committee in compliance with the Sarbanes-Oxley Act of 2002; and

WHEREAS, Section 5.4 of the Amended and Restated Member Control Agreement of the Company provides for the establishment of Committees by majority vote of the Board of Governors; and

WHEREAS, a lengthy discussion of the issues took place and afterward the following resolutions were adopted on a motion made, seconded, and unanimously carried.

NOW THEREFORE, BE IT RESOLVED, that the form, terms and provisions of the Code of Ethics and the Audit Committee Charter be hereby adopted as set forth in Exhibits A and B hereto;

RESOLVED, that the Audit Committee be formed pursuant to Section 5.4 of the Operating Agreement of the Company, which Audit Committee has the responsibilities required by the Sarbanes-Oxley Act of 2002; and

RESOLVED, that George Goblish, David Moldan, ______, and Ron Jorgenson be appointed to the Audit Committee.

Timothy J. Van Der Wal

Timothy J. Van Der Wal, Secretary

Approved:

Brian Kletscher

Brian Kletscher, Chairman

EXHIBIT A

HIGHWATER ETHANOL, LLC
Code of Ethics for Chief Executive and Senior Financial Officers

Highwater Ethanol, LLC (the "Company") is honest and ethical in all of its business dealings and the Code of Ethics for Chief Executive and Senior Financial Officers (the "Code of Ethics") embodies principles to which the Company's representatives are expected to adhere and advocate. The Company has adopted the following Code of Ethics specifically for its Chief Executive and Senior Financial Officers. Any violations of the Code of Ethics may result in disciplinary action, up to and including termination of employment.

1. You are responsible for full, fair, accurate, timely and understandable financial disclosure in reports and documents filed by the Company with the Securities and Exchange Commission and in other public communications made by the Company. The Company's accounting records must be maintained in accordance with all applicable laws, must be proper, supported, and classified, and must not contain any false or misleading entries.

2. You are responsible for the Company's system of internal financial controls. You shall promptly bring to the attention of Danielle Smid at Brown, Winick, Graves, Gross, Baskerville, and Schoenebaum, P.L.C. (the "Company's Legal Counsel") and the Audit Committee any information you may have concerning (a) significant deficiencies in the design or operation of internal controls which could adversely affect the Company's ability to record, process, summarize, and report financial data, or (b) any fraud, whether or not material, that involves management or other employees who have a significant role in the Company's financial reporting, disclosures, or internal controls.

3. You must act honestly and ethically. You may not compete with the Company and may never let business dealings on behalf of the Company be influenced by personal or family interests. You shall promptly bring to the attention of the Company's Legal Counsel and the Audit Committee any information you may have concerning any actual or apparent conflicts of interest between personal and professional relationships, involving any management or other employees who have a significant role in the Company's financial reporting, disclosures, or internal controls.

4. The Company is committed to complying with both the letter and the spirit of all applicable laws, rules, and regulations. You shall promptly bring to the attention of the Company's Legal Counsel and the Audit Committee any information you may have concerning evidence of a material violation of the securities or other laws, rules, or regulations applicable to the Company or its employees or agents. You shall promptly bring to the attention of the Company's Legal Counsel and Audit Committee any information you may have concerning any violation of this Code of Ethics. The Board of Governors may determine, or designate appropriate persons to determine, appropriate additional disciplinary or other actions to be taken in the event of violations of this Code of Ethics by the Company's Chief Executive or Senior Financial Officers and a procedure for granting any waivers of this Code of Ethics.

5. The Company will not retaliate against a governor, officer or employee who provides information to the federal government or a supervisor or testifies about any matter than an employee reasonably believes constitutes a violation of federal securities law or any provision of federal law relating to fraud against shareholders.

By my signature below, I acknowledge receipt of the above Highwater Ethanol, LLC Code of Ethics for Chief Executive and Senior Financial Officers.

Brian D. Kletscher, President and Governor (Principal Executive Officer)

Jason R. Fink, Treasurer and Governor (Principal Financial and Accounting Officer)

EXHIBIT B
HIGHWATER ETHANOL, LLC
CHARTER OF THE AUDIT COMMITTEE OF THE BOARD OF GOVERNORS

I. Purpose

The Audit Committee ("Committee") is appointed by the Board of Governors ("Board") of Highwater Ethanol, LLC (the "Company") to assist the Board in fulfilling its oversight responsibilities. The primary duties and responsibilities of the Audit Committee are to:

- Monitor the integrity of the Company's financial reporting process and systems of internal controls regarding finance, accounting, legal and regulatory compliance;
- Appoint, compensate, retain and monitor the independence and qualifications of the Company's independent auditors (also referred to herein as external auditors);
- Monitor the performance of the Company's internal audit function and independent auditors;
- Provide an avenue of communication among the independent auditors, management, and the Board; and
- Prepare an Audit Committee report as required by the Securities and Exchange Commission ("SEC") to be included in the Company's annual proxy statement.

II. Authority

The Committee shall have the authority to conduct or authorize any investigation appropriate to fulfill its responsibilities, and is empowered to:

- Appoint, compensate, retain and oversee the work of the public accounting firm employed by the Company to conduct the annual audit who shall report directly to the Committee;
- Retain independent counsel and other advisers as it deems necessary in the performance of its duties;
- Resolve any disagreements between management and the independent auditor regarding financial reporting;
- Pre-approve all auditing and permitted non-audit services performed by the Company's external audit firm;

- Seek any information it requires from employees—all of whom are directed to cooperate with the Committee's requests—or external parties;

- Meet with Company officers, external auditors, or outside counsel, as necessary;

- Delegate authority to subcommittees including the authority to pre-approve all auditing and permitted non-audit services, providing that such decisions are presented to the full Committee at its next scheduled meeting; and

- Determine appropriate funding for the payment of compensation to the independent auditors engaged for the purpose of issuing an audit report, performing other audit review or attestation services for the Company and to any advisers employed by the Committee which funding must be paid for by the Company.

III. Composition

1. Committee members' qualifications shall meet the requirements as may be set by the Board from time to time, in addition to all applicable legal and regulatory requirements.

2. The Committee shall be comprised of at least three independent governors of the Company (as defined in subparagraph 3 of this Article III below), all in good standing, each of whom must be able to read and understand fundamental financial statements, including the Company's balance sheet, income statement, statement of members' equity and cash flow statement.

3. A governor will NOT be considered independent for purposes of this Article III, if such governor:

   (a) Receives any consulting, advisory, or other compensatory fees from the Company, other than Board or committee fees and fixed amounts of compensation under a retirement plan (including deferred compensation) for prior service with the Company (provided that such compensation is not contingent in any way on continued service);

   (b) Is an "affiliated person" of the Company, the definition of which is attached hereto as Exhibit 1;

   (c) Is an employee of the Company or any current subsidiary of the Company;

   (d) Has accepted or has a family member who has accepted payments from the Company or any of its subsidiaries in excess of $60,000, other than as compensation for Board or Board committee service, payments arising solely from investments in the Company's securities, compensation paid to a family member who is a non-executive employee of the Company, benefits under a tax-qualified retirement plan, or non-discretionary compensation, or certain permitted loans;

(e) Has a family member who is employed by the Company or any of its subsidiaries as an executive officer;

(f) Is or has a family member who is a partner or controlling shareholder or an executive officer of any organization to which the Company made, or from which the Company received, payments for property or services that exceeds 5% of the recipient's consolidated gross revenues of that year, or $200,000, whichever is more, other than payments arising solely from investments in the Company's securities or payments under non-discretionary charitable contribution matching programs;

(g) Is or has a family member who is employed as an executive officer of another entity where any of the executive officers of the Company serve on the compensation committee of such other entity; or

(h) Is or has a family member who is a current partner of the Company's outside auditor who worked on the Company's audit;

4. Committee members and a Committee chair shall be recommended and appointed by the Board.

IV. Meetings

The Committee shall meet as often as it determines, but not less frequently than quarterly. The Committee shall meet separately, periodically with management, with internal auditors, if any, and with external auditors. The Committee may request any officer or employee of the Company or the Company's outside counsel or independent auditor to attend a meeting of the Committee or to meet with any members of, or consultants to, the Committee. All members are expected to attend each meeting, in person or via teleconference or video-conference.

The minutes of each meeting are to be prepared at the direction of the Audit Committee Chair and sent to Committee members and all other governors. Copies are to be promptly provided to the independent auditors and the Company's legal counsel.

V. Scope of Responsibilities and Duties

Charter Review

Review and reassess the adequacy of this charter annually. Consider changes that are necessary as a result of new laws and regulations. Recommend any proposed changes to the Board. Submit the charter to the Board for approval and publish the document as required.

Financial Reporting

Review the Company's annual audited financial statements and the documents containing such filings prior to filing or distribution. The review should include discussion with management and independent auditors of the following:

- Significant issues regarding accounting principles, practices, audit findings, disclosures, judgments and any other requirements under accounting standards and rules;

- Complex or unusual transactions and areas in which an unusual degree of judgment must be exercised;

- The effect of regulatory and accounting initiatives, as well as off-balance sheet structures, on the financial statements of the Company; and

- "Quality of earnings" of the Company from a subjective as well as objective standpoint.

Review analyses prepared by management and/or the independent auditor setting forth significant financial reporting issues and judgment made in connection with the preparation of the financial statements, including analyses of the effects of alternative GAAP methods on the financial statements.

Review with management and the external auditors the results of the audit, including any difficulties encountered. This review will include any restrictions on the scope of the independent auditors' activities or on access to requested information, and any significant disagreement with management.

Discuss the annual audited financial statements and quarterly financial statements with management and external auditors, including the Company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations." Consider any items required to be communicated by the independent auditors in accordance with Statements of Accounting Standards ("SAS") No. 61, *Communications with Audit Committee* (relating to the conduct of the audit and the application of significant accounting policies and estimates), SAS No. 89, *Audit Adjustments* (relating to audit adjustments) and SAS No. 90, *Audit Committee Communications* (relating to the quality, not just the acceptability, of the Company's accounting principles and estimates), all as amended from time to time, which are attached to this charter as Exhibit 2.

Review disclosures made by Principal Executive Officer and Principal Financial Officer in the Forms 10-KSB or 10-K and 10-QSB or 10-Q certification process about significant deficiencies in the design or operation of internal controls or any fraud that involves management or other employees who have a significant role in the Company's internal control.

Internal Control

Consider the effectiveness of the Company's internal control system, including information technology, security and control.

Understand the scope of the external auditor's review of internal control over financial reporting, and obtain reports on significant findings and recommendations, together with management's responses.

Internal Audit

In the event the Company employs an internal audit department, the Committee shall:

Review with management the charter, plans, activities, staffing and organizational structure of the internal audit function.

Review the effectiveness of the internal audit function.

Independent Auditors

Each year, review the independence and performance of the independent auditors and retain or discharge the independent auditors as circumstances warrant. In performing this review, the Committee will:

At least annually, obtain and review a report by the independent auditor describing: the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (to assess the auditor's independence) all relationships between the independent auditor and the Company.

Take into account the opinions of management and, in the event the Company has employed an internal audit, the opinions of the internal audit department.

Present its conclusions with respect to the external auditor to the Board.

Prescribe such policies and procedures as the Committee deems appropriate pertaining to relationships with the independent auditors, including clear hiring policies for employees and former employees of the independent auditors.

Approve the independent auditors' engagement terms and fees for annual audit services as well as advance approval of all non-audit engagements with that firm. Any such approval of non-audit services by the independent auditor shall be disclosed in periodic reports as prescribed by law.

On at least an annual basis, review a formal, written statement from the independent auditors on such matters as are prescribed by law, including all relationships between the auditors and the Company or its management. Discuss with the independent auditors all significant relationships they have with the Company and their impact on the auditors' objectivity and independence, including non-audit services and the fees proposed and charged therefore. Take appropriate action in response to these matters to satisfy itself of the auditors' independence.

Review the independent auditors audit plan; discuss scope, staffing, locations, reliance upon management, and general audit approach, including coordination of audit effort with the internal audit department, if any.

Ensure the rotation of the lead audit partner and other audit partners as required by law, and consider whether there should be regular rotation of the audit firm itself.

Present its conclusions with respect to the independent auditor to the Board.

Meet separately with the external auditors on a regular basis to discuss any matters that the committee or auditors believe should be discussed privately.

Review all material written communications between the independent auditors and management, e.g., management letter, schedule of unadjusted differences and/or reportable conditions letter.

Compliance

At least once annually, review with the Company's legal counsel any legal matters that could have a significant impact on the Company's financial statements, the Company's compliance with applicable laws and regulations (in coordination with other committees), and inquiries received from regulators or governmental agencies.

Establish procedures for: (i) The receipt, retention, and treatment of complaints received by the Company regarding accounting, internal accounting controls, or auditing matters; and (ii) The confidential, anonymous submission by employees of the Company of concerns regarding questionable accounting or auditing matters.

Review the process for communicating the Code of Ethics to appropriate Company personnel, and for monitoring compliance therewith.

Obtain regular updates from management and Company legal counsel regarding compliance matters.

Reporting Responsibilities

Annually prepare such report and certification to unit holders as required by SEC regulations.

Report to the Board about Committee activities and issues that arise with respect to the quality or integrity of the Company's financial statements, the Company's compliance with legal and regulatory requirements, the performance and independence of the Company's independent auditors, and, in the event the Company has employed an internal audit department, the performance of the internal audit function.

Other Audit Committee Responsibilities

Discuss and review with management the Company's major policies with respect to risk assessment and risk management.

As considered necessary by the Committee, review policies and procedures as well as audit results associated with governors' and officers' expense accounts and perquisites, including the use of the Company's assets.

Perform any other activities consistent with this Charter, the Company's operating agreement, and governing law, as the Committee or the Board deems necessary or appropriate.

Periodically review materials or receive education on Audit Committee-related and new accounting and auditing-related developments and best practices.

Annually evaluate the Committee's performance of its responsibilities, confirm that all responsibilities outlined in this charter have been carried out, and create an agenda for the ensuing year.

EXHIBIT 1

The term *affiliate* of, or a person *affiliated* with, a specified person, means a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified.

(A) A person will be deemed not to be in control of a specified person for purposes of this section if the person:

1. Is not the beneficial owner, directly or indirectly, of more than 10% of any class of voting equity securities of the specified person; and

2. Is not an executive officer of the specified person.

(B) The previous paragraph (Subparagraph A) of this section only creates a safe harbor position that a person does not control a specified person. The existence of the safe harbor does not create a presumption in any way that a person exceeding the ownership requirement in the previous paragraph (Subparagraph A) of this section controls or is otherwise an affiliate of a specified person.

The following will be deemed to be affiliates:

(A) An executive officer of an affiliate;

(B) A governor who also is an employee of an affiliate;

(C) A general partner of an affiliate; and

(D) A managing member of an affiliate.

For purposes of the previous paragraph (Subparagraph A) of this section, dual holding companies will not be deemed to be affiliates of or persons affiliated with each other by virtue of their dual holding company arrangements with each other, including where governors of one dual holding company are also governors of the other dual holding company, or where governors of one or both dual holding companies are also governors of the business jointly controlled, directly or indirectly, by the dual holding companies (and, in each case, receive only ordinary-course compensation for serving as a member of the board of governors, audit committee or any other board committee of the dual holding companies or any entity that is jointly controlled, directly or indirectly, by the dual holding companies).

EXHIBIT 2

AU Section 380

Communication With Audit Committees

Source: SAS No. 61; SAS No. 89; SAS No. 90.

See section 9380 for interpretations of this section.

Effective for audits of financial statements for periods beginning on or after January 1, 1989, unless otherwise indicated.

.01 This section establishes a requirement for the auditor to determine that certain matters related to the conduct of an audit are communicated to those who have responsibility for oversight of the financial reporting process.[1] For purposes of this document, the recipient of the communications is referred to as the *audit committee*. The communications required by this section are applicable to (1) entities that either have an audit committee or that have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee (such as a finance committee or budget committee) and (2) all Securities and Exchange Commission (SEC) engagements.[2]

.02 This section requires the auditor to ensure that the audit committee receives additional information regarding the scope and results of the audit that may assist the audit committee in overseeing the financial reporting and

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[1] Communication with the audit committee by the independent auditor on certain specified matters when they arise in the conduct of an audit is required by other standards, including—

- Section 325, *Communication of Internal Control Related Matters Noted in an Audit.*
- Section 316, *Consideration of Fraud in a Financial Statement Audit.*
- Section 317, *Illegal Acts by Clients.*
- Section 801, *Compliance Auditing Considerations in Audits of Governmental Entities and Recipients of Governmental Financial Assistance.*

In addition, section 722, *Interim Financial Information*, requires that certain information be communicated to audit committees as a result of performing a review of interim financial information. [Footnote revised, November 2002, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 100.]

[2] For purposes of this section, an SEC engagement is defined as one that involves the audit of the financial statements of—

1. An issuer making an initial filing, including amendments, under the Securities Act of 1933 and the Securities Exchange Act of 1934.
2. A registrant that files periodic reports with the SEC under the Investment Company Act of 1940 or the Securities Exchange Act of 1934 (except a broker or dealer registered only because of section 15(*a*) of the 1934 Act).
3. A bank or other lending institution that files periodic reports with the Comptroller of the Currency, the Federal Reserve System, the Federal Deposit Insurance Corporation, or the Federal Home Loan Bank Board because the powers, functions, and duties of the SEC to enforce its periodic reporting provisions are vested, pursuant to section 12(*i*) of the 1934 Act, in those agencies. (Section 12(*g*) of the Securities Exchange Act of 1934 provides an exemption from periodic reporting to the SEC to [1] entities with less than $5 million in total assets on the last day of each of the entity's three most recent fiscal years and fewer than 500 shareholders and [2] entities with fewer than 300 shareholders. Accordingly, such entities are not encompassed within the scope of this definition.)
4. A company whose financial statements appear in the annual report or proxy statement of any investment fund because it is a sponsor or manager of such a fund, but which is not itself a registrant required to file periodic reports under the 1940 Act or section 13 or 15(*d*) of the Securities Exchange Act of 1934.

disclosure process for which management is responsible. This section does not require communications with management; however, it does not *preclude* communications with management or other individuals within the entity who may, in the auditor's judgment, benefit from the communications.

.03 The communications may be oral or written. If information is communicated orally, the auditor should document the communication by appropriate memoranda or notations in the working papers.[3] When the auditor communicates in writing, the report should indicate that it is intended solely for the information and use of the audit committee or the board of directors and, if appropriate, management, and is not intended to be and should not be used by anyone other than these specified parties.

.04 The communications specified by this section are incidental to the audit. Accordingly, they are not required to occur before the issuance of the auditor's report on the entity's financial statements so long as the communications occur on a timely basis. There may be occasions, however, when discussion of certain of the matters (specified by paragraphs .06 through .14 below) with the audit committee prior to the issuance of the report may, in the auditor's judgment, be desirable.

.05 It may be appropriate for management to communicate to the audit committee certain of the matters specified in this section. In such circumstances, the auditor should be satisfied that such communications have, in fact, occurred. Generally, it is not necessary to repeat the communication of recurring matters each year. Periodically, however, the auditor should consider whether, because of changes in the audit committee or simply because of the passage of time, it is appropriate and timely to report such matters. Finally, this section is not intended to restrict the communication of other matters.

Matters to Be Communicated

The Auditor's Responsibility Under Generally Accepted Auditing Standards

.06 An audit performed in accordance with generally accepted auditing standards may address many matters of interest to an audit committee. For example, an audit committee is usually interested in internal control and in whether the financial statements are free of material misstatement. In order for the audit committee to understand the nature of the assurance provided by an audit, the auditor should communicate the level of responsibility assumed for these matters under generally accepted auditing standards. It is also important for the audit committee to understand that an audit conducted in accordance with generally accepted auditing standards is designed to obtain reasonable, rather than absolute, assurance about the financial statements.

Significant Accounting Policies

.07 The auditor should determine that the audit committee is informed about the initial selection of and changes in significant accounting policies or

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[3] The auditor may wish to review the minutes, if any, prepared by the audit committee for consistency with the auditor's understanding of the communications. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 2000, by Statement on Auditing Standards No. 90.]

their application. The auditor should also determine that the audit committee is informed about the methods used to account for significant unusual transactions and the effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus. For example, significant accounting issues may exist in areas such as revenue recognition, off-balance-sheet financing, and accounting for equity investments.

Management Judgments and Accounting Estimates

.08 Accounting estimates are an integral part of the financial statements prepared by management and are based upon management's current judgments. Those judgments are normally based on knowledge and experience about past and current events and assumptions about future events. Certain accounting estimates are particularly sensitive because of their significance to the financial statements and because of the possibility that future events affecting them may differ markedly from management's current judgments. The auditor should determine that the audit committee is informed about the process used by management in formulating particularly sensitive accounting estimates and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.

Audit Adjustments

.09 The auditor should inform the audit committee about adjustments arising from the audit that could, in his judgment, either individually or in the aggregate, have a significant effect on the entity's financial reporting process. For purposes of this section, an audit adjustment, whether or not recorded by the entity, is a proposed correction of the financial statements that, in the auditor's judgment, may not have been detected except through the auditing procedures performed. Matters underlying adjustments proposed by the auditor but not recorded by the entity could potentially cause future financial statements to be materially misstated, even though the auditor has concluded that the adjustments are not material to the current financial statements. [As amended, effective for audits of financial statements for periods beginning on or after December 15, 1999, by Statement on Auditing Standards No. 89.]

.10 The auditor also should inform the audit committee[4] about uncorrected misstatements aggregated by the auditor during the current engagement and pertaining to the latest period presented that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole.[5] [Paragraph added, effective for audits of financial statements for periods beginning on or after December 15, 1999, by Statement on Auditing Standards No. 89.]

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[4] The presentation to the audit committee should be similar to the summary of uncorrected misstatements included in or attached to the management representation letter. See footnote 6 of section 333, *Management Representations*. [Footnote added, effective for audits of financial statements for periods beginning on or after December 15, 1999, by Statement on Auditing Standards No. 89.]

[5] The communication to management and the audit committee of immaterial misstatements aggregated by the auditor does not constitute a communication pursuant to section 317.17, Section 10A of the Securities Exchange Act of 1934, or section 316.79–.82. The auditor may have additional communication responsibilities pursuant to section 317, Section 10A of the Securities Exchange Act of 1934, or section 316. [Footnote added, effective for audits of financial statements for periods beginning on or after December 15, 1999, by Statement on Auditing Standards No. 89. Footnote revised, January 2004, to reflect conforming changes necessary due to the issuance of Statement on Auditing Standards No. 99.]

Auditor's Judgments About the Quality of the Entity's Accounting Principles

.11 In connection with each SEC engagement (see paragraph .01), the auditor should discuss with the audit committee the auditor's judgments about the quality, not just the acceptability, of the entity's accounting principles as applied in its financial reporting. Since the primary responsibility for establishing an entity's accounting principles rests with management, the discussion generally would include management as an active participant. The discussion should be open and frank and generally should include such matters as the consistency of the entity's accounting policies and their application, and the clarity and completeness of the entity's financial statements, which include related disclosures. The discussion should also include items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements.[6] Examples of items that may have such an impact are the following:

- Selection of new or changes to accounting policies
- Estimates, judgments, and uncertainties
- Unusual transactions
- Accounting policies relating to significant financial statement items, including the timing of transactions and the period in which they are recorded

Objective criteria have not been developed to aid in the consistent evaluation of the quality of an entity's accounting principles as applied in its financial statements. The discussion should be tailored to the entity's specific circumstances, including accounting applications and practices not explicitly addressed in the accounting literature, for example, those that may be unique to an industry. [Paragraph added, effective for audits of financial statements for periods ending on or after December 15, 2000, by Statement on Auditing Standards No. 90.]

Other Information in Documents Containing Audited Financial Statements

.12 The audit committee often considers information prepared by management that accompanies the entity's financial statements. An example of information of this nature would be the "Management's Discussion and Analysis of Financial Condition and Results of Operations" that certain entities that file reports with the SEC are required to present in annual reports to shareholders. Section 550, *Other Information in Documents Containing Audited Financial Statements*, establishes the auditor's responsibility for such information.[7] The auditor should discuss with the audit committee his responsibility

[6] These characteristics of accounting information are discussed in the Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*. FASB Concepts Statement No. 2 notes that consistently understating results or overly optimistic estimates of realization are inconsistent with these characteristics. [Footnote added, effective for audits of financial statements for periods ending on or after December 15, 2000, by Statement on Auditing Standards No. 90.]

[7] Guidance on the auditor's consideration of other information is also provided by section 558, *Required Supplementary Information*; section 551, *Reporting on Information Accompanying the Basic Financial Statements in Auditor-Submitted Documents*; and section 711, *Filings Under Federal Securities Statutes*. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 90, December 1999.]

for other information in documents containing audited financial statements, any procedures performed, and the results. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 90, December 1999.]

Disagreements With Management

.13 Disagreements with management may occasionally arise over the application of accounting principles to the entity's specific transactions and events and the basis for management's judgments about accounting estimates. Disagreements may also arise regarding the scope of the audit, disclosures to be included in the entity's financial statements, and the wording of the auditor's report. The auditor should discuss with the audit committee any disagreements with management,[8] whether or not satisfactorily resolved, about matters that individually or in the aggregate could be significant to the entity's financial statements or the auditor's report. For purposes of this section, disagreements do not include differences of opinion based on incomplete facts or preliminary information that are later resolved. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 90, December 1999.]

Consultation With Other Accountants

.14 In some cases, management may decide to consult with other accountants about auditing and accounting matters. When the auditor is aware that such consultation has occurred, he should discuss with the audit committee his views about significant matters that were the subject of such consultation.[9] [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 90, December 1999.]

Major Issues Discussed With Management Prior to Retention

.15 The auditor should discuss with the audit committee any major issues that were discussed with management in connection with the initial or recurring retention of the auditor including, among other matters, any discussions regarding the application of accounting principles and auditing standards. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 90, December 1999.]

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[8] The glossary to Financial Accounting Standards Board (FASB) Statement No. 57, *Related Party Disclosures* [AC section R36], defines management as follows:

> Persons who are responsible for achieving the objectives of the enterprise and who have the authority to establish policies and make decisions by which those objectives are to be pursued. Management normally includes members of the board of directors, the chief executive officer, chief operating officer, vice presidents in charge of principal business functions (such as sales, administration, or finance), and other persons who perform similar policy-making functions. Persons without formal titles also may be members of management.

[Footnote renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 90, December 1999.]

[9] Circumstances in which the auditor should be informed of such consultations are described in section 625, *Reports on the Application of Accounting Principles*, paragraph .07. [Footnote renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999. Footnote subsequently renumbered by the issuance of Statement on Auditing Standards No. 90, December 1999.]

Difficulties Encountered in Performing the Audit

.16 The auditor should inform the audit committee of any serious difficulties he encountered in dealing with management related to the performance of the audit. This may include, among other things, unreasonable delays by management in permitting the commencement of the audit or in providing needed information, and whether the timetable set by management was unreasonable under the circumstances. Other matters that the auditor may encounter include the unavailability of client personnel and the failure of client personnel to complete client-prepared schedules on a timely basis. If the auditor considers these matters significant, he should inform the audit committee. [Paragraph renumbered by the issuance of Statement on Auditing Standards No. 89, December 1999. Paragraph subsequently renumbered by the issuance of Statement on Auditing Standards No. 90, December 1999.]

Effective Date

.17 This section is effective for audits of financial statements for periods beginning on or after January 1, 1989. Early application of the provisions of this section is permissible.

