



# External Audit and the Audit Committee Beyond the Basics

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**HCCA**

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# Introduction

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*“An audit committee or audit committee member can not insulate himself or herself from liability by burying his or her head in the sand. In every financial reporting matter we investigate, we will look at the audit committee”*

Stephen Cutler  
Former SEC Director of Enforcement

# Agenda

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✓ **The Basics**

– *A review of roles and responsibilities*

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✓ **Beyond the Basics**

– *Practices for improved effectiveness*

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✓ **Current Status and Lessons Learned**

– *The hard way*

# The Basics

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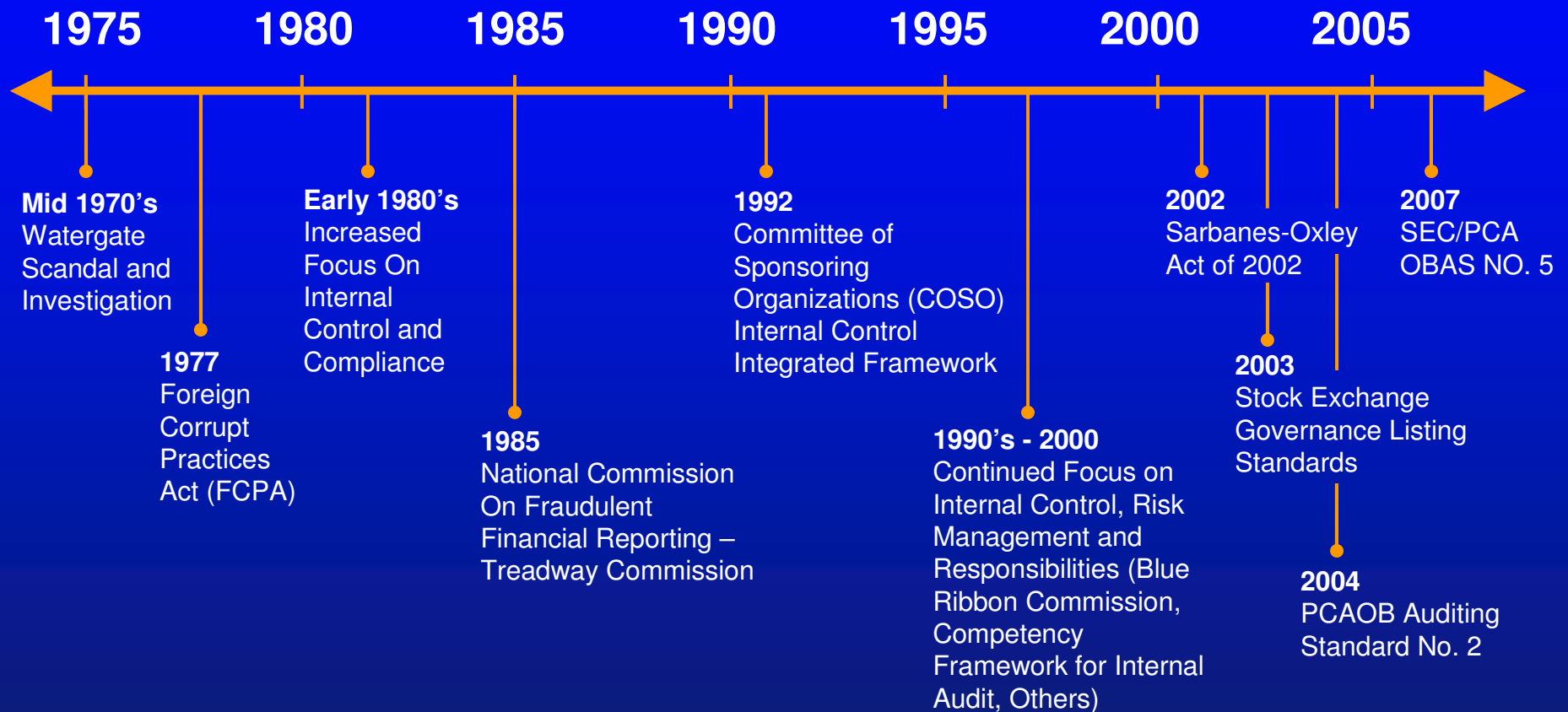


# The Basics

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- **Audit Committee Reform**
- **Key Areas of Responsibility:**
  - ✓ Composition & Competencies
  - ✓ Oversight of External Auditor
  - ✓ Oversight of Financial Reporting
  - ✓ Risk Oversight
  - ✓ Ethics & Compliance

# Timeline of Reform



# Common Audit Committee Responsibilities

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- Oversee the integrity of the financials
- Review financial-related disclosures
- Hire and oversee the external auditor, including selection of the lead partner
- Oversee internal audit
- Review internal controls
- Monitor risk exposures and ensure adequate disclosure
- Manage relationships among management, internal audit and independent auditors
- Review related-party transactions
- Whistleblower compliance
- Consider adequacy/quality of finance organization
- Oversight of compliance w/laws and regulations (NYSE)



**Deloitte Resource: Audit Committee Performance Evaluation**



# Composition & Competency

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## Sarbanes Oxley Act

- Specific requirement for at least one “audit committee financial expert”
- Board independence requirements, which also apply to the audit committee

## Stock Exchanges

- Additional independence requirements
- Reiterated financial literacy requirements for all members of the audit committee
- Annual performance assessments required – (NYSE only)

## SEC Item 407 of Regulation S-K

- Enhanced disclosure of director business relationships



**Deloitte Resources: New Corporate Governance Listing Standards;  
Deloitte Dbrief, What Do the New SEC Rules on Executive  
Compensation Mean for your Company?**

# Auditor Oversight

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## SEC Rule 10A & Sarbanes – Oxley Section 301 & 204

- Appoint, compensate, retain, and oversee independent auditor
- Preapproval on nonaudit services
- Hold timely discussions with the auditor regarding:
  - Critical accounting policies and practices
  - Alternative accounting treatments
  - Material, written communications between the auditor and management

## NYSE Listing Standards



## Deloitte Resource: New Corporate Governance Listing Standards

- Meet periodically with the external auditor in executive session
- Set clear hiring policies
- Review quality control processes and results of practice/peer reviews
- Confirm auditor independence

# Evaluating the External Auditor

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## To consider when choosing an external auditor:

- Independence & Quality Control
  - Example: What are the firm's processes for addressing compliance with independence and conflicts?
- Firm & Industry Capabilities
  - What are the firm's stats (size, industry presence, service capability, etc.)
- Engagement Team
  - Professional background of engagement team
- Communications & Service Approach
  - Approach to communicating with audit committee, how often, what types of communication?
- Engagement Planning & Risk Assessment
  - Approach for assessing risk, how does the assessment impact the audit procedures?
- Consultation & Technical Matters
  - Process for resolving difficult or controversial issues
- Fee Structure
  - How is the fee determined, what services are included?
- Technology & Value-Added Benefits
  - How will use of technology provide value-added service
- Auditor Change & Transition
  - What is the firm's transition plan for taking over the audit



**Deloitte Resource:  
Checklist for Gathering  
Information About the  
External Auditor**

# Oversight of Financial Reporting

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## Sarbanes Oxley Act

- Audit committee reviews and discusses with management all Section 302 and 906 certifications
- Audit committee reviews management's report on internal control and the independent auditor's attestation on management's assertion

## Stock Exchanges

- Explicit requirements for charter – includes responsibility for oversight of the accounting and financial reporting process



**Deloitte Resource: New Corporate Governance Listing Standards**

# Financial Reporting – Who's Responsible?

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## Management Responsibilities

- Responsible for financial reporting, accounting, internal controls
  - Includes selection of accounting standards, judgments and estimates, adequate disclosure
  - Must make certain quarterly and annual certifications
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## Auditor Responsibilities

- Responsible for attestation of audited financial statements, and internal controls (for public companies subject to Section 404 of Sarbanes)
  - Required to communicate certain items to the audit committee
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## Audit Committee Responsibilities

- Responsible for oversight of financial reporting, internal controls, external and internal audit
- Consider quality and adequacy of finance organization

# Oversight of Ethics and Compliance

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## Sarbanes-Oxley Requirements

- Oversight of whistleblower programs
- Code of ethics for senior financial management
- Require public disclosure of waivers to the code

## Stock Exchange Requirements

- Extend code of ethics to employees and directors

## Federal Sentencing Guidelines' 2004 Amendments

### *Multiple requirements for the board*

- Oversight of program, including monitoring of effectiveness
- Delegation of authority
- Board education on its compliance responsibilities



**D&T Resource: Questions the Board Should Ask About Ethics & Compliance Programs**



# Risk Oversight

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## Stock Exchange

### Audit Committee Responsibilities (NYSE)

- Discuss & consider risk assessment and management policies
- Meet with internal audit to discuss ongoing risk processes and systems of internal control

## SEC's MD&A Guidance

### Include in MD&A

- Insight into material opportunities, challenges and risks
- Known material trends and uncertainties

***Source: Interpretation - Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations; Securities and Exchange Commission; 17 CFR Parts 211, 231 and 241; [Release Nos. 33-8350; 34-48960; FR-72]***

# Suggested Questions for Audit Committees to Consider

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The audit committee might consider asking the following:

- Has management evaluated the impact of the SEC's guidance on current efforts?
- How does management evaluate risk? What procedures and programs are in place to mitigate risks identified?
- Is additional controls rationalization necessary to facilitate a focus on the highest risk, key control areas?
- How does management plan to change its documentation and testing strategies as a result of the SEC guidance?
- Are there opportunities for the audit team to rescope work?
- Has the audit team coordinated efforts with management's plans to implement the SEC guidance?
- Are there any areas where the auditor will not achieve efficiencies to the greatest extent because of efforts that management will/will not (did/did not) do?

# Other Basic Practices

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- Audit Committee Performance Assessments
  - Periodic self-assessment
  - Include financial literacy considerations
  - Auditors (indirectly) required to consider audit committee in the context of “entity level controls”
- Continuing education
  - Full committee or for individual members
  - Public forums vs. customized training
- Extensive reporting of relationships
  - Annual director questionnaire to identify potential conflicts of interest

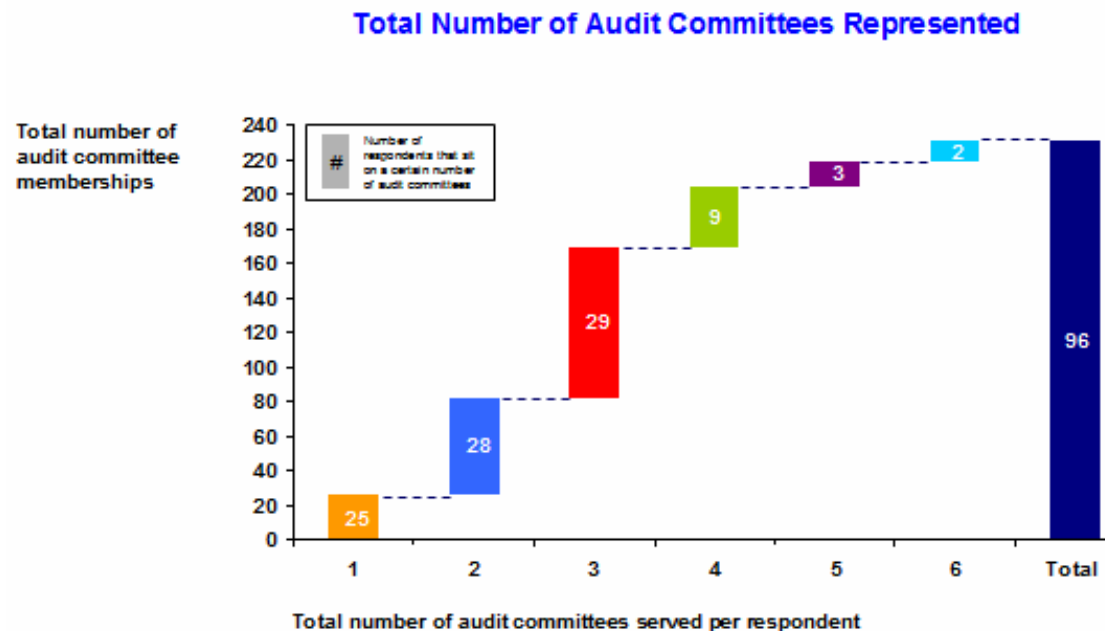


**Deloitte Resource: Audit Committee Performance Evaluation (see also AICPA Conducting an Audit Committee Self-Evaluation)**

# Audit Committee Member Research – Number of Committees Served

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- Interviews of 96 respondents
  - Broad cross section of industries and geographies
  - Split roughly 50/50 between members and chairs
  - Represented 224 audit committees
    - Interviewees served on an average of 2.3 audit committees



\*The gross number of audit committees that are served is 231, but there are only 224 different companies represented in the sample

# Audit Committee Member Research – Relationship with the External Auditor

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- Interactions with the external auditor
  - The respondents recognized the challenges for the external auditor in maintaining appropriate independence while still supporting productive working relationships
  - Effective relationships require more time, preparation, and specialized knowledge
  - Audit committee members look to their auditors to keep them informed about key aspects of the company that may affect the financial reporting function and to report anything the auditor believes should be considered by the audit committee as the company prepares its financial reports

# Beyond The Basics

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# Beyond the Basics

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## Key Areas of Focus

- ✓ Risk Intelligence
- ✓ Fraud Risk

# Risk Aversion v. Risk Intelligence

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**Risk aversion ignores the basic principle of risk v. reward  
Companies should be averse to unrewarded risks  
e.g., ethical & non-compliance risks**

# Rewarded Risk is the Basis of Capitalism

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*“This nation was built by men who took risks - pioneers who were not afraid of the wilderness, business men who were not afraid of failure, scientists who were not afraid of the truth, thinkers who were not afraid of progress, dreamers who were not afraid of action.”*

Brooks Atkinson



**Deloitte Resources: Risk Intelligence Series,  
Issues Nos. 1 and 2**

# Understanding the Company's Risk Profile

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- Board of Directors

- Oversight of major organizational risks

- Determine extent and type of acceptable risk
    - Monitor management process for various types of business risk
    - Identify early warning indicators
    - Keep pace with the changing strategic environment & key business risks
    - Understand management's mitigation of risks

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- Financial Risk v. Financial Reporting Risk

**Source: Report of the NACD Blue Ribbon Commission on: Audit Committees**

# Understanding the Company's Risk Profile, cont.

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- Audit Committee

- Oversight of financial risk

- ✓ Understand organization's principal financial reporting risks
    - ✓ Assess organization's internal controls
      - Objectives
      - Areas for remediation
      - Management override considerations
    - ✓ Foster a strong internal control environment
    - ✓ Oversight of fraud risk assessment

# Fraud – Oversight Responsibilities

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- Fraud risk assessment
  - Oversee the management's processes and understand identified fraud risks
- Antifraud control environment
  - Strong tone emphasizing ethical behavior
- Design and implementation of antifraud programs and control activities
  - Oversee management's process for matching control activities with fraud risks
- Communicating and sharing information
  - Company's philosophy on fraud prevention
- Monitoring activities
  - Ongoing assessment of quality and effectiveness



**Deloitte Resource: Fraud and the Role of the Audit Committee**



# If Something Goes Wrong?

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Questions that will be asked with the benefit of hindsight.

- Was the committee sufficiently involved or simply listeners?
- Did they demonstrate an appropriate level of skepticism?
- Was the whistleblower hotline effective or simply in place to comply with regulatory requirements?
  - Were they simply “checking the box”?
- Did it even occur to the audit committee that those who design the control processes can override them?



**Source: AICPA Management Override of Internal Controls:  
The Achilles' Heel of Fraud Prevention**

# Current Status and Lessons Learned

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# Current Status and Lessons Learned

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- ✓ Where Are We Today?
- ✓ Audit Effectiveness Blockers

# Where Are We Today?

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- SEC approved AS 5 on July 25, 2007, to replace Auditing Standard No. 2 (AS 2)
  - Timeline or adoption of section 404 by non-accelerated filers
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# Overview of AS 5 as Approved by SEC & PCAOB

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- AS 5, *An Audit of ICFR that is Integrated with an Audit of Financial Statements*, was approved by the SEC on July 25, 2007, and replaces AS 2

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- AS 5 was effective for audits of fiscal years ending on or after November 15, 2007

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- PCAOB concluded that the framework regarding the use of internal auditors' work in AU 322 is appropriate to use when considering the use of work of others in an integrated audit and did not adopt the proposed auditing standard relating to this topic.
  - Instead, AS 5 instructs the auditor to use the existing AU 322 framework

## AS 5 is Intended to Achieve Four Principles:

1. Focus the audit on the matters most important to ICFR
2. Eliminate unnecessary procedures
3. Facilitate scaling the audit for smaller companies
4. Simplify the requirements

# Audit Committee Effectiveness Blockers

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1. Responsibility for establishing the Audit Committee meeting agendas is delegated to management
2. Meeting materials distributed without enough time for thoughtful review
3. Meeting scheduled at same time as other board committee meetings
4. Executive sessions with the auditor are on an “as-needed basis”
5. Meeting timeline is too tight - important topics breezed over in “the interest of time”
6. Management screens materials and topics suggested by external auditor

# Audit Committee Effectiveness Blockers

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7. Using auditor comments to attack management performance
8. Quarterly meetings limited to applicable filings
9. Board delegates tasks outside of core functions-  
“audit committee overload”
10. Members that are unqualified, unengaged, absent, or have a personal agenda
11. Each member assumes the others understand the issues

# Deloitte Resources

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- Audit Committee Resource Guide
- Audit Committee Performance Evaluation (sample questionnaire)
- Dbriefs Webcasts
  - Available series focused on Audit Committee and governance trends and developments: [www.deloitte.com/us/dbriefs](http://www.deloitte.com/us/dbriefs)
- Center for Corporate Governance Web Site:  
[www.corpgov.deloitte.com](http://www.corpgov.deloitte.com)
  - Publicly available site to access key resources on governance and related issues. Provides the latest research and information on leading practices for directors and board committees.



# Questions?

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**Deloitte.**