



External Audit and the Audit Committee Beyond the Basics

HCCA

**Audit & Compliance Committee Conference
October 2007**

Steve Burrill

**AERS National Industry Leader
Deloitte & Touche LLP**

Introduction



“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

✓ **The Basics**

– *A review of roles and responsibilities*

✓ **Beyond the Basics**

– *Practices for improved effectiveness*

✓ **Current Status and Lessons Learned**

– *The hard way*

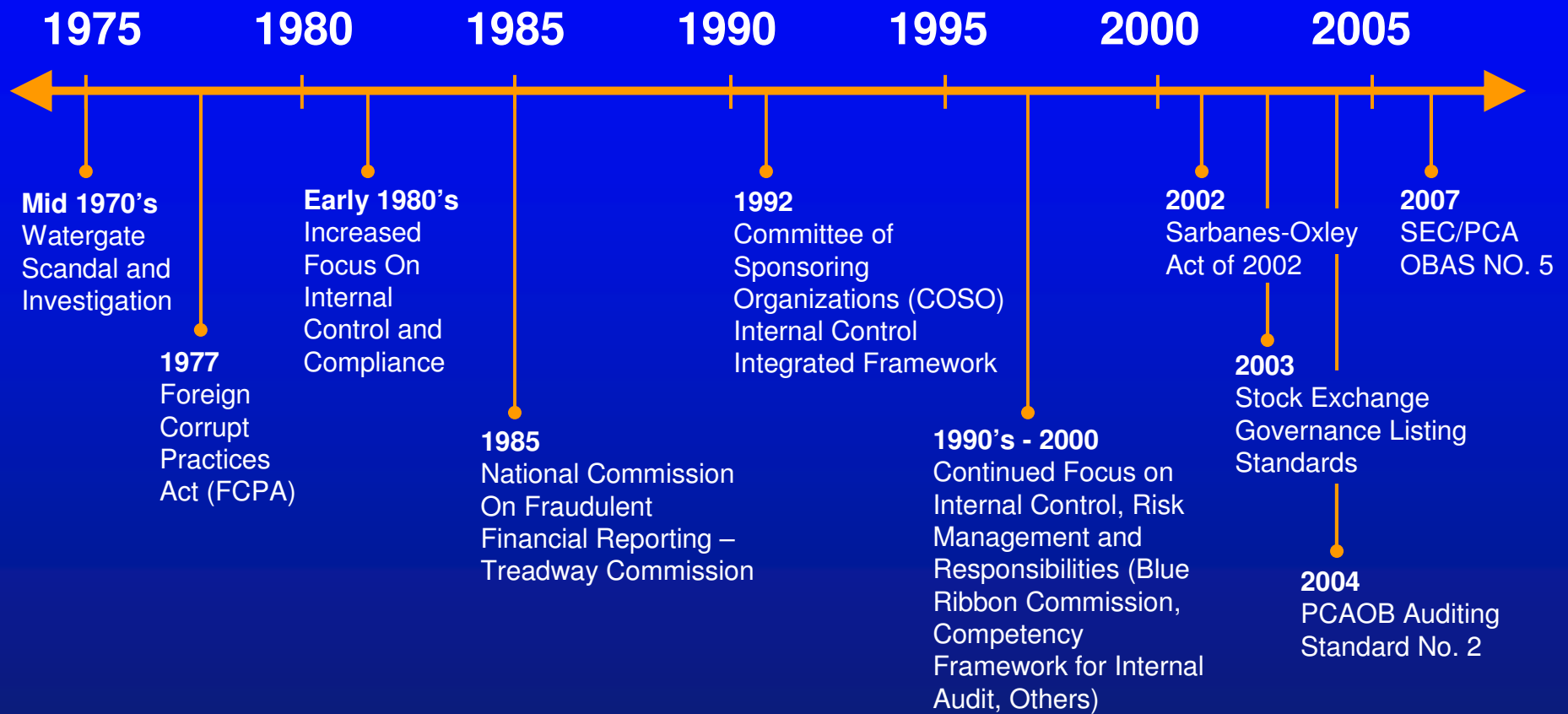
The Basics



The Basics

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

Timeline of Reform



General Audit Committee Responsibilities

- 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

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

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

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

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?

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
-

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
-

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

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

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

The audit committee might consider asking the following:

- Has management evaluated the impact of the SEC’s guidance on current efforts?
- How is management evaluating risk and are changes needed for “lower risk” areas?
- Is additional controls rationalization necessary to facilitate a focus on the highest risk, key control areas?
- How, if at all, will management alter 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

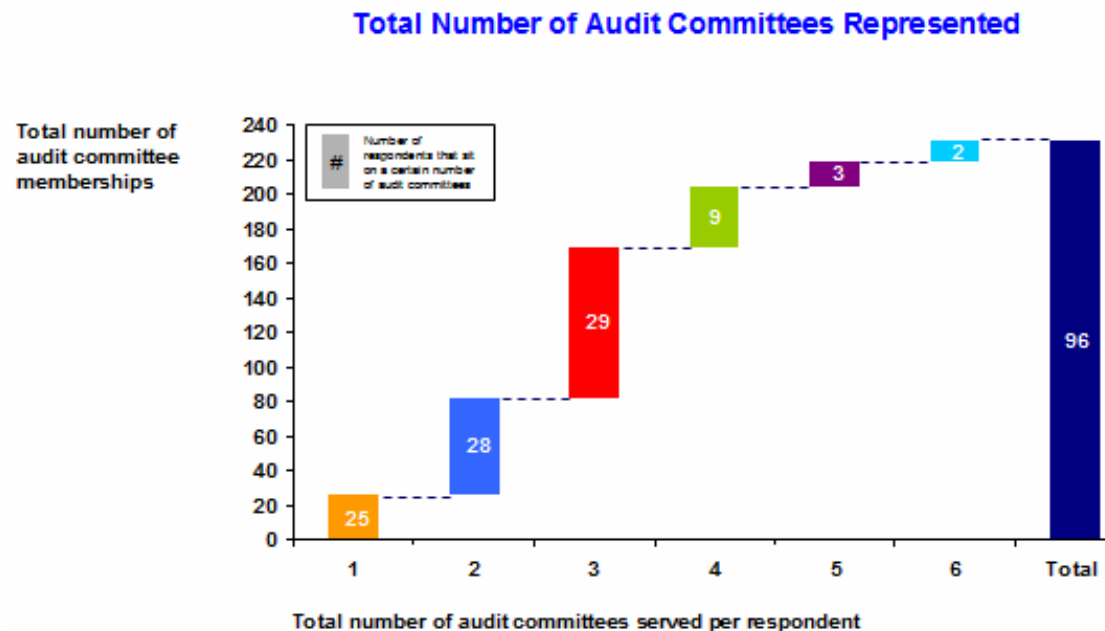
- Audit Committee Performance Assessments
 - Periodic self-assessment
 - Include financial literacy considerations
 - Auditors (indirectly) required to consider audit committee in the context of “entity level controls”
- Continuing education
 - Full committee or for individual members
 - Public forums 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 – Relationship with the External Auditor

- 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, cont.

- 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



Beyond the Basics

Key Areas of Focus

- ✓ Risk Intelligence
- ✓ Fraud Risk

Risk Aversion v. Risk Intelligence



**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

“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

- 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
-

- Financial Risk v. Financial Reporting Risk

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

Understanding the Company's Risk Profile, cont.

- 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

- 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?

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



Current Status and Lessons Learned

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

Where Are We Today?

- SEC approved Section 404 management guidance on May 23, 2007, and it was posted on June 20, 2007, to the SEC's website
-
- Public Company Accounting Oversight Board (PCAOB) approved its new auditing standard (AS 5) on May 24, 2007
-
- SEC approved AS 5 on July 25, 2007, to replace Auditing Standard No. 2 (AS 2)

Overview of AS 5 as Approved by SEC & PCAOB

- 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 will replace AS 2

- AS 5 is effective for audits of fiscal years ending on or after November 15, 2007, with earlier adoption permitted

- PCAOB also concluded that the framework regarding the use of internal auditors' work in AU 322 is also 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

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

Audit Committee Effectiveness Blockers

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

Deloitte Resources

- Audit Committee Resource Guide, June 2006
- Audit Committee Performance Evaluation, March 2006 – sample questionnaire
- Dbriefs Webcasts
 - Available series focused on Audit Committee and governance trends and developments: www.deloitte.com/us/dbriefs
- Center for Corporate Governance Web Site:
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?

Deloitte.