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Board Matters

# Staying on course

A guide for audit committees



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# Staying on course

## A guide for audit committees

**The role of the audit committee in corporate governance is more important than ever. As an audit committee member, your ongoing journey will be filled with many stops along the way.**

The U.S. Congress, Securities and Exchange Commission (SEC), New York Stock Exchange (NYSE), NASDAQ and Public Company Accounting Oversight Board (PCAOB) continue to place significant responsibility on the audit committee and its members.

The audit committee is expected to monitor company risk, the integrity of the company's financial statements and internal controls, the qualifications and independence of the company's independent auditor, the performance of both the company's internal audit function and its independent auditor, and the company's compliance with laws and regulations.

In this resource guide, we provide audit committee members with important information to help them understand their role and responsibilities as they navigate the governance landscape and perform their duties. We also provide helpful tools, including examples of an audit committee charter, an audit committee report, a financial expertise questionnaire, a meeting planner and a self-assessment tool for audit committees. In addition, the Questions section includes a variety of inquiries you can make of management, internal audit professionals or the independent auditors on selected topics and performance.

While the information in this publication is geared to public company audit committees, it also may be a good resource for those serving private company or nonprofit organizations. Finally, please note that the information provided is current as of December 2013. You can find news on the latest developments affecting audit committees using the resources on [page 29](#) of this document.

We hope you find this resource guide and the tools useful in helping you to fulfill your fiduciary responsibilities.

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**01**

# Planning your route

# Responsibilities and related rules

The SEC requires that every US company listed on an exchange have an audit committee or its equivalent as part of its board of directors. As an audit committee member, it's important to understand the rules and regulations designed to guide audit committee members in the performance of their oversight role.

## Sarbanes-Oxley Act of 2002

Among its many duties, the audit committee is required to:

- ▶ Obtain and review a report by the independent auditor describing the auditor's internal quality control procedures, as well as all relationships between the auditor and the company, including recently raised issues and steps taken to address those issues
- ▶ Meet and discuss the annual audited financial statements and quarterly financial statements with management and the independent auditor, including the company's specific disclosures under Management's Discussion and Analysis (MD&A) of Financial Condition and Results of Operations
- ▶ Discuss the company's earnings and press releases, as well as financial information and earnings guidance
- ▶ Assess the company's risk assessment and risk management policies
- ▶ Meet separately with management, internal auditors and independent auditors on a periodic basis
- ▶ Review with the independent auditor any problems or difficulties encountered in the audit and management's response
- ▶ Report regularly to the board of directors

## Audit committee members – independence and financial expertise

The Sarbanes-Oxley Act of 2002 (SOX or the Act) built on changes made by the SEC and US stock exchanges in the late 1990s regarding audit committee member independence. SOX Section 301 enhanced and codified SEC and US stock exchange rules. SOX requires all listed-company audit committee members to not be affiliated with the company or any subsidiaries. They also cannot receive direct or indirect compensation from the company, other than for serving as board members.

To be considered "independent" under SOX Section 301, an audit committee member may not accept any consulting, advisory or other compensatory fees from the issuer or be an "affiliated person" of the issuer or a subsidiary.

Section 407 requires companies to disclose whether they have a financial expert, and if not, why not. Having someone with financial expertise puts the audit committee in a stronger position to review and challenge the company's financial statements, determine whether internal controls are appropriate and sufficient and, if necessary, perform certain actions to protect shareholder interests.

### Independence of the independent auditor

SOX Sections 201 and 202 require audit committees to preapprove all audit and non-audit services. The Act makes it unlawful for audit firms to perform nine specifically listed categories of non-audit services for public companies they audit. The Act also specifically indicates that audit firms are not prohibited from performing any other non-audit service for a public audit company, as long as such services are preapproved by the company's audit committee.

### Oversight of the independent auditor

SOX Section 301 requires the audit committee to oversee the independent auditor's work and be directly responsible for the auditor's appointment and compensation.

The independent auditor is required to provide the audit committee with regular reports on the company's application of accounting principles. It also must report to the audit committee on:

- ▶ The company's accounting policies and practices
- ▶ All alternative treatments of financial information within US generally accepted accounting principles (GAAP) that have been discussed with management, including the ramifications of using the alternative treatments and the treatment preferred by the auditor
- ▶ Any disagreements with management about matters that could be significant to the company's financial statements or the auditor's reports
- ▶ Other material written communications between the auditor and management

### Responding to potential violations

Section 301 also states that an audit committee must:

- ▶ Establish procedures for receiving and treating complaints about accounting and auditing matters, including complaints from those who wish to remain anonymous
- ▶ Have the authority to engage independent counsel and other advisors, as it deems necessary, to help it carry out its duties
- ▶ Receive corporate attorneys' reports of evidence of any material violation of securities laws or breaches of fiduciary duty

Under SOX Section 307, the SEC established rules requiring attorneys appearing before it to report evidence of a material violation of securities laws or breach of fiduciary duty or similar violation by the company to the issuer's chief legal counsel or the chief executive officer. If management does not appropriately respond to the evidence, the attorney must report the evidence to the audit committee.

### PCAOB Rule 3526

When independent auditors communicate with the companies they audit and potential clients, they must follow standards established by the PCAOB (the Board).

In April 2008, the PCAOB adopted Ethics and Independence Rule 3526, *Communication with Audit Committees Concerning Independence*. Under the rule, an independent auditor must do the following before accepting an initial engagement:

- ▶ Describe, in writing, to the audit committee of the issuer all relationships between the independent auditor or affiliates of the firm and the potential audit client or persons in financial reporting oversight roles at the potential client that, as of the date of the communication, may reasonably be thought to bear on the firm's independence
- ▶ Discuss with the audit committee the potential effects of those relationships on the independence of the independent auditor, if it is appointed as the issuer's auditor
- ▶ Document the substance of its discussion with the audit committee of the issuer

The independent auditor must also follow the same three steps for each of its issuer audit clients, at least annually. It also must affirm to the audit committee in writing that, as of the date of the communication, the independent auditor is independent and in compliance with PCAOB independence rules.

## PCAOB release for audit committees about its inspection process

The PCAOB issued *Information for Audit Committees about the PCAOB Inspection Process* to help public company audit committees understand the PCAOB's inspections of independent auditors and help audit committees gather useful information about those inspections from the independent auditors.

The release was motivated, in part, by feedback the Board received from audit committee members who said they would welcome more dialogue about the inspection process and the results of inspections. It was also motivated by the Board's view that, in some instances, audit firms were reluctant to discuss inspection results or had de-emphasized the importance of any adverse findings.

The release encourages audit committees to consider asking the auditors a number of questions, including:

- ▶ Was the company's audit selected for PCAOB inspection?
- ▶ If so, has anything come to the audit firm's attention suggesting the possibility that the audit opinions are not sufficiently supported or that its independence or the fairness of the company's financial statements and disclosures is being questioned?
- ▶ Has the PCAOB identified deficiencies in the company's audit, or in other audits that involved auditing, accounting or internal control over financial reporting issues similar to issues presented in the company's audit?
- ▶ Do similar deficiencies exist in the company's audit, and if so, what has been done in response?
- ▶ What were the audit firm's responses to the PCAOB's findings?
- ▶ What topics are included in the audit firm's Part II findings; what steps is the firm taking to address them; and has the PCAOB determined that such findings have been addressed to its satisfaction?
  - ▶ What changes is the firm making to address any quality control deficiencies?

- ▶ What is the progress of the quality control remediation process, including a discussion of any submissions the audit firm made to the PCAOB as part of that process?
- ▶ For which inspected years has the PCAOB made a final determination about the firm's remediation efforts, and what is the nature of that determination?
- ▶ Has the PCAOB provided initial indications that the audit firm may not have sufficiently remediated any items?

## Communication between the independent auditor and the audit committee

PCAOB Accounting Standard No. 16, *Communications with Audit Committees* (AS 16), which became effective for audits of fiscal years beginning on or after December 15, 2012, is intended to enhance the relevance, timeliness and quality of communications between the auditor and audit committee about significant audit and financial statement matters. Among the requirements of AS 16 are the following:

- ▶ **Acknowledgement of terms of the audit** – The auditor is required to provide the engagement agreement to the audit committee annually, and the audit committee has to acknowledge and agree to the terms. While the standard says this acknowledgement can be either oral or in writing, audit committees should consider including a discussion of the engagement agreement on the meeting agenda and document its agreement in the meeting minutes.
- ▶ **Obtaining information relevant to the audit** – In addition to current inquiries regarding fraud risks, the auditor needs to inquire of audit committee members whether they are aware of other matters relevant to the audit, including violations or possible violations of laws or regulations.
- ▶ **Audit strategy** – The auditor is required to provide details about the audit strategy, including the timing of the audit and significant risks identified by the auditor, as well as any significant changes to the planned strategy or significant



In recent years, investors, policymakers and regulators have shown growing interest in more detailed disclosure about corporate audit committees, their activities and their oversight of the relationship with independent auditors.

risks identified and the reasons for any changes. The following audit strategy elements are required to be communicated:

- ▶ The nature and extent of any specialized skill or knowledge required to execute the audit
  - ▶ The extent to which the auditors will rely on the work of internal auditors or others
  - ▶ The names, locations and planned responsibilities of other independent public accounting firms (including affiliated firms)
  - ▶ The basis for the determination that the auditor can serve as principal auditor when significant parts of the audit will be performed by another independent public accounting firm
- ▶ **Accounting policies and practices, estimates, significant unusual transactions and the auditor's evaluation of the company's financial reporting** – Auditors are required to communicate the following:
- ▶ How management developed the critical accounting estimates; any significant assumptions related to such estimates that have a high degree of subjectivity; any significant changes in the processes or assumptions used to make these estimates; the effects of those changes on the financial statements; and the basis for the auditor's conclusion regarding the reasonableness of the critical accounting estimates, including any bias the auditor identifies in management's judgments related to accounting estimates
  - ▶ Significant unusual transactions outside the normal course of business or that otherwise appear unusual due to their timing, size or nature, the policies and practices that management used to account for those transactions and the auditor's understanding of the business rationale for those transactions
  - ▶ The results of the auditor's evaluation of whether the financial statements and related disclosures conform with the applicable financial accounting framework, including the auditor's consideration of the form, arrangement and content of the financial statements (e.g., the terminology used, the amount of detail given, the classification of items, the bases of amounts set forth)
- ▶ Situations when the auditor identified a concern about management's planned application of a new accounting pronouncement that may have a significant effect on future financial reporting (e.g., the auditor believes management's information technology systems would be unable to provide the data to apply the new accounting pronouncement)
  - ▶ **Consultation outside the engagement team** – Auditors are required to communicate matters that are difficult or contentious when they consult outside the engagement team on such matters, and when they determine that these matters are relevant to the audit committee's oversight. Difficult or contentious issues are described as critical matters that concern the auditor when he or she is making the final assessment of whether the financial statements are presented fairly. (A difficult issue may require consultation; a contentious one leads to disagreement, debate or deliberation between the auditor and management.)
  - ▶ **Going concern** – Auditors are required to communicate conditions and events that indicate substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time. If the auditor concludes that substantial doubt is alleviated, the auditor is required to communicate the basis for that conclusion, including management's plans that led to the auditor's conclusion. If the substantial doubt is not mitigated, the auditor is required to describe the effect of the uncertainty on the financial statements and the auditor's report.
  - ▶ **Uncorrected and corrected misstatements** – Auditors are required to provide management with a schedule of uncorrected misstatements and to discuss, or determine that management has adequately discussed, the basis for determining that identified uncorrected misstatements were immaterial, including the qualitative factors considered and any effect the uncorrected misstatements may have on future financial statements. The auditor also must communicate to the audit committee those corrected misstatements (other than those that are clearly trivial) related to accounts and disclosures that might not have been detected except through the auditing procedures performed.



The auditor must also communicate the implications that such corrected misstatements might have on the company's financial reporting process.

The PCAOB standard recognizes that, in many instances, management already discusses certain information with the audit committee about critical and significant accounting policies and practices, significant estimates or significant unusual transactions, and that requiring the auditor to make similar communications would not benefit the audit committee. As a result, the auditor is not required to repeat certain of the required communications if management has already discussed them, as long as the auditor performs the following:

- ▶ Participates in management's discussion with the audit committee
- ▶ Confirms to the audit committee that management has adequately communicated these matters
- ▶ Identifies any accounting policies and practices that the auditor considers to be critical
- ▶ Communicates any omitted and inadequately described matters

While auditors are not required to repeat management's communications about factual information regarding policies, estimates and significant transactions, auditors must communicate their evaluation of these matters.

For the audits of non-issuers (e.g., brokers and dealers) that don't have an audit committee or board of directors, these communications are required to be made to the person(s) designated to oversee the accounting and financial reporting processes and the audits of the entity's financial statements. The auditor is required to identify the bodies or persons that oversee the accounting, auditing and financial reporting processes. Communications need not be made to parties outside the governance structure of the audited entity (e.g., the audit committee of a broker's or dealer's parent company when the broker or dealer is audited).

AS 16 allows the communications to be either written or oral. AS 16 also requires that these communications occur in a timely manner before the issuance of the auditor's report.

## Audit committee reporting to shareholders

Various SEC rules require certain audit- and audit committee-related information to be disclosed in the proxy statement, as well as in the audit committee report and on company websites. In recent years, investors, policymakers and regulators have shown growing interest in more detailed disclosure about corporate audit committees, their activities and their oversight of the relationship with independent auditors. Some institutional investors have advocated for increased transparency and requested that some audit committees provide specific information in the proxy statement related to the committee's oversight responsibilities and various audit firm matters.

As investors request additional clarification about the roles and responsibilities of audit committees, audit committees should consider whether it makes sense to enhance disclosures and, if so, whether the enhancements should be made in the audit committee report or in the proxy statement. Some companies have chosen to provide additional disclosures, while others are waiting for specific guidance from regulators. 🗨️

➔ For more information, see *Example Report of the audit committee in Examples*.

➔ Read more in *Audit committee reporting to shareholders* published by EY and available on [ey.com](https://www.ey.com).



A high-speed train, blurred due to motion, is traveling along a track in a modern station. The station features a large, arched glass and steel roof structure. The train is red and white, and the tracks curve into the distance. The overall scene is captured in a wide-angle shot, emphasizing the scale of the infrastructure.

02

Keeping  
on track



# The audit committee's oversight role

With so many responsibilities, it is important to stay on track. To perform their oversight responsibilities, audit committee members need to collect the right information, analyze it carefully, ask appropriate questions and make informed decisions.

## Overview

There has been ongoing debate about the role of the board of directors versus the audit committee (and the board's other standing committees) in the oversight of risk. The NYSE governance standards recognize that the audit committee is "not the sole body responsible for risk." However, the standards do require the audit committee to "discuss policies with respect to risk assessment and risk management."

## Risk and controls

The SEC requires the board to disclose its role in risk oversight. Management is responsible for identifying what it deems to be the company's key risks, while the audit committee's main focus is on risks that affect the financial statements. The board oversees strategic and operational risks, although the audit committee may be involved. The goal should be for companies and boards to foster a culture where risks are identified and challenged at all levels of the organization.

Management must create and maintain an effective internal control system, including internal controls over financial reporting, to mitigate internal and external risks, and it should refresh its approach to evaluating internal controls every year. Audit committees should question whether their companies are designing and maintaining internal controls in a way that

keeps pace with economic and business conditions, changes in the company's operations and emerging financial reporting standards.

A key aspect of risk oversight is to ascertain whether the company has policies and controls to prevent and detect fraud. The audit committee needs to understand the fraud risks identified by management, how those risks are monitored and controlled, and whether there are additional risks that should be considered.

## Compliance with laws and regulations

The audit committee may also assist the board in monitoring compliance with laws and regulations. In addition to reviewing reports from regulators about company compliance, the audit committee should meet periodically with compliance officers and the general counsel to better understand the company's compliance process.

Now more than ever, the public focuses on the reputation of a business. Consequently, companies should adopt and adhere to a formal code of ethics. The code of ethics can help establish a culture among employees where ethical behavior thrives, helping deter fraud. While the audit committee is not responsible for determining ethical standards, it is often consulted when a company is developing or challenging its code of ethics.



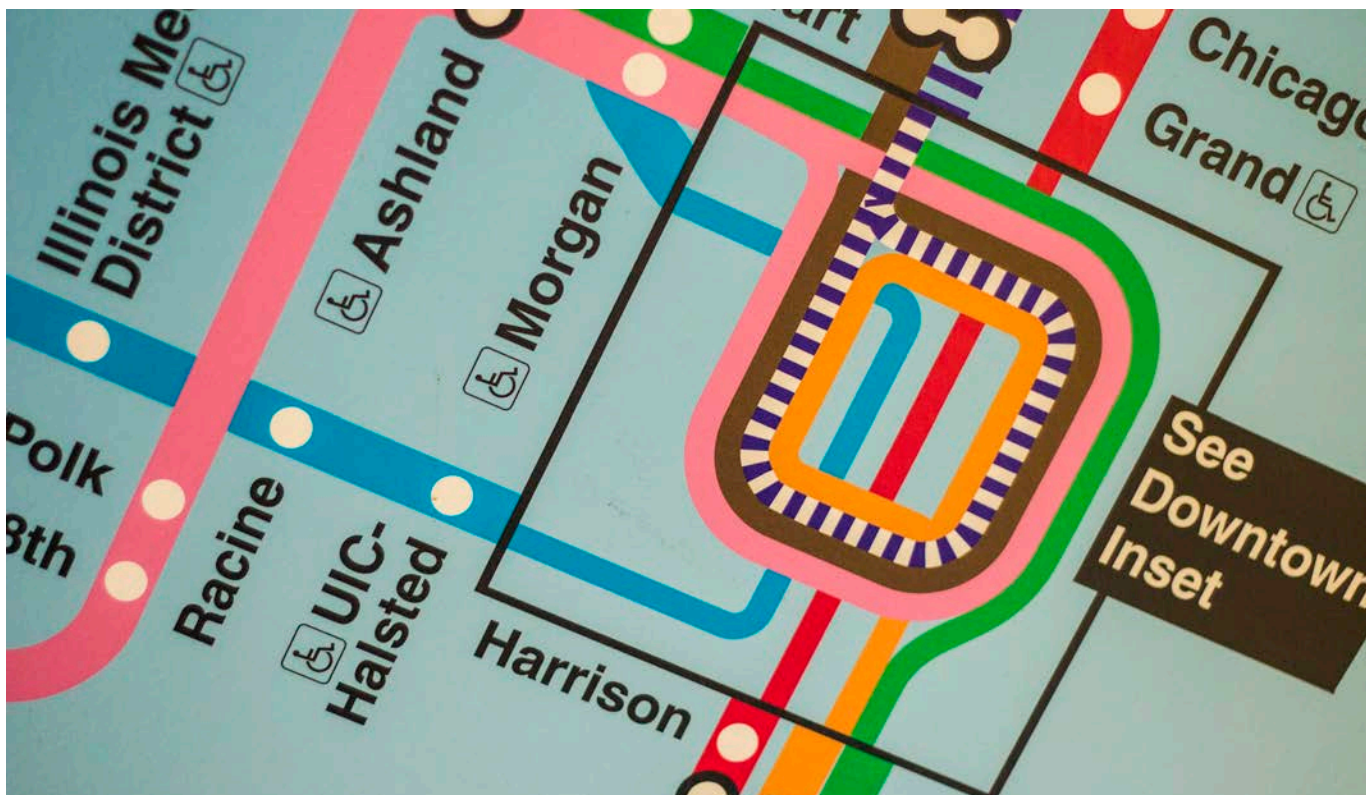
The U.S. Department of Justice has increased the number of cases prosecuting alleged foreign bribery by US corporations, forcing companies to take costly steps to prevent potential bribery. Enforcement action under the Foreign Corrupt Practices Act (FCPA) now extends across five continents and penetrates entire industries.

Another law that is reshaping the regulatory oversight landscape is the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Dodd-Frank applies to every public company – not just companies in the financial sector – and affects corporate governance, compensation, SEC enforcement and derivatives. Regulators are implementing provisions

of Dodd-Frank, and the rule-making process warrants the attention of all public company boards.

The UK and China enacted anti-bribery laws in 2011. The UK Bribery Act (the Bribery Act) represents a unified law that carries heavy penalties for wrongdoers. The Bribery Act signified a fundamental change in the UK’s approach to prosecuting corruption, and the authorities have already made a significant investment in enforcement.

The offenses set forth in the Bribery Act go significantly beyond the FCPA, covering all bribery, regardless of whether it involves a public official, with no exemption for facilitation



payments or promotional expenditure. It also introduces an explicit offense for failing to prevent bribery by associated parties. The Bribery Act affects not just UK-incorporated businesses, but potentially the global operations of any foreign business with a UK presence. Businesses should examine their existing anticorruption measures, benchmark themselves against industry norms and assess what improvements they should make.

China amended its criminal law prohibiting bribery of foreign officials in 2011. The amendments forbid individuals and corporations from providing “money or property to any foreign party performing official duties or any official of international public organizations for the purpose of seeking illegitimate business benefits.”

Leading compliance practices for combating bribery and corruption include taking a risk-based approach to compliance and internal audit efforts and using data mining tools to track unusual transactions. When potential bribery and corruption issues are discovered, audit committees should consider proactively contacting the authorities, such as the Serious Fraud Office in the UK and the U.S. Department of Justice.

## Fraud risks

During economic downturns, companies are typically under significant pressure to reduce costs and still achieve budgeted or forecasted results. In this environment, it is especially important to make certain that management has identified the appropriate fraud risks and implemented sufficient controls to detect these risks and prevent them from becoming a reality. The audit committee should challenge whether management has an appropriate focus on these controls and is setting the appropriate tone at the top. Fraud risks are further discussed on [page 13](#).

# Leading practices

## Audit committee’s risk oversight role

- ▶ Understand the company’s framework for risk assessment and management’s related policies and procedures
- ▶ Understand how the company documents and responds to identified risks
- ▶ Review whether the company is appropriately focusing on its risk intelligence gathering and assessment processes, and understand the company’s ability to both identify emerging risks and anticipate risk events
- ▶ Review whether the risk disclosures in the financial statements and the Form 10-K are appropriate, robust and understandable
- ▶ Review the company’s major financial risk areas, and understand the adequacy of controls and monitoring procedures in place
- ▶ Periodically reassess the list of top risks, determining who in management and which board committees are responsible for each
- ▶ Meet directly with key executives responsible for risk management and focus on whether they understand they should inform the committee of extraordinary risk issues and developments that require the committee’s immediate attention outside of the regular reporting process
- ▶ Focus on the company’s plans for achieving any information technology (IT) milestones, especially for IT transformation projects, given the importance of IT to most organizations
- ▶ Understand the use, if any, of emerging technologies such as cloud computing, as well as their relevance to the company and the associated risks
- ▶ Understand whether IT security processes are updated appropriately

## Financial reporting risk

A primary responsibility of the audit committee is to oversee the integrity of the company's internal controls over financial reporting, accounting and reporting practices and financial statements. As financial reporting becomes more complex, the audit committee should determine whether the financial statements are understandable and transparent.

Management has the primary responsibility for preparing a company's financial statements and disclosures. The audit committee's responsibilities include the oversight of management's internal controls over financial reporting and management's process for preparing the financial statements. To accomplish this, the audit committee actively engages management to help committee members understand the financial statements and disclosures. It is important for the audit committee to make sure that the financial statements are understandable and transparent.

In performing its review, the audit committee should ask management for an overview of judgmental or key areas included within the financial statements. The audit committee also should focus on new accounting pronouncements adopted during the reporting period, critical accounting policies, risk factors, internal control deficiencies, and significant accounting matters and disclosures. The audit committee should discuss these matters with the independent auditors and review any internal control deficiencies that have been identified and the processes they affect.

The audit committee should also understand what the independent auditors deemed to be significant risks, as well as any difficult or contentious issues requiring the audit team to consult with its national office.

→ For more information, see questions in the *Financial reporting* section on page 31.

## Leading practices

### Financial reporting risk

- ▶ Consider whether the company reports information that is reliable and understandable
- ▶ Understand complex accounting and reporting issues, such as fair value accounting and related assumptions, and how management addresses them
- ▶ Continue to focus on pension obligations, asset impairments, quality of earnings, cash flows and liquidity position and other ongoing financial statement issues affected by economic conditions
- ▶ Review significant financial reporting and regulatory developments, including their effect on the financial statements and on the company's resource needs
- ▶ Learn about the company's operations and significant risks
- ▶ Assess the quality of the accounting principles and their appropriateness, considering alternative treatments under US GAAP
- ▶ Inquire about management's consideration of its revenue recognition policies, including how the company accounts for complex revenue arrangements and whether any changes in revenue recognition policies were made in the current year



In performing their review, the audit committee should ask management for an overview of judgmental or key areas included within the financial statements.

## Oversight of internal controls

Internal controls form an integral part of a company's enterprise risk management. While the audit committee's key focus is on internal controls over financial reporting, it is increasingly assisting with the board's legal and regulatory compliance efforts, particularly the "books and records" provisions of the FCPA.

Management has a responsibility to establish and maintain adequate internal controls over financial reporting. For public companies, SOX Section 404 requires management to annually evaluate and report on the effectiveness of these controls. Under SOX Section 302, the chief executive and the chief financial officer (CFO) are required to make quarterly certifications about the effectiveness of the internal controls over financial reporting.

The audit committee is responsible for overseeing these controls and reviewing how management has complied with Sarbanes-Oxley. This oversight can be accomplished through discussing and reviewing various work products with management, internal auditors and independent auditors.

As part of the audit process, the independent auditor must provide the audit committee with written communication about all material weaknesses and significant deficiencies in internal control. The audit committee should understand the control deficiencies identified and management's plans to remediate them.

The company should design internal control processes to keep up with economic and business conditions, changes in the company's operations and emerging financial reporting risks. The audit committee also should challenge management to leverage the value of controls so that internal control processes and assessments do not become simply compliance exercises.

→ For more information, see questions in the *Internal controls* section on page 38.

## Leading practices

### Oversight of internal controls

- ▶ Understand key controls and financial reporting risk areas as assessed by financial management, the internal auditor and the independent auditor, as well as mitigating controls and safeguards
- ▶ Understand risk issues involving taxes (over the past several years, income tax accounting has led to a number of restatements and has had one of the highest frequencies of material weaknesses)
- ▶ Understand internal audit's role and planned coverage
- ▶ Meet with the internal audit director on a regular basis
- ▶ Assess and help set the company's tone at the top
- ▶ Consider levels of authority and responsibility in key areas, including pricing and contracts, acceptance of risk, commitments and expenditures
- ▶ Monitor implementation of significant internal control changes
- ▶ Determine whether the company devotes the resources required for its internal control processes to function effectively

Without the right culture and tone at the top, people facing great pressures may be tempted to commit fraud if they have the opportunity.

## Fraud risks and factors

The audit committee plays an important role in representing investors' interests through its oversight of a company's financial reporting. Integral to that oversight is understanding how fraud risks are identified and assessed so that appropriate antifraud programs and processes can be established. A fraud risk assessment should be performed on a regular basis and be customized to address the specific circumstances of the organization (e.g., industry, geography, size). The audit committee should know the company's tolerance for identified fraud risks and help align antifraud procedures with the business strategy. While considering all these factors, the audit committee must then oversee the design, execution and monitoring of antifraud controls.

Fraudulent financial reporting need not be the result of a grand plan or conspiracy. Individuals may rationalize the appropriateness of a misstatement, for example, as an aggressive rather than indefensible interpretation of complex accounting rules. Or they may see it as a temporary misstatement of financial statements, to be corrected later when operational results improve, or as something that is in the best interests of the company or the employees. But whatever the rationalization, these individuals would intend to mislead financial statement users.

Fraud can be accomplished through manipulating, falsifying or altering accounting records or supporting documents; providing incomplete or misleading disclosures; intentionally misapplying accounting principles; applying management overrides of controls; or exerting other inappropriate influence over the financial reporting process.

### Fraud risk factors

Management and those charged with governance of the entity share the primary responsibility for preventing and detecting fraud. Management must strongly emphasize fraud prevention and fraud deterrence. This emphasis involves establishing a

culture of honesty and ethical behavior, reinforced by active oversight by those charged with governance.

Those who are charged with governance of the entity are responsible for making sure that management establishes and maintains internal controls to provide reasonable assurance about the reliability of financial reporting.

As the audit committee considers fraud risk factors, it should keep in mind the "fraud triangle," or three conditions that generally are present when fraud exists: incentives or pressures, opportunities and attitudes.

The presence of fraud risk factors does not necessarily mean that fraud exists. However, if numerous fraud risk factors are present, a greater focus on fraud prevention and detection is generally needed. Following are fraud risk factors as discussed in the PCAOB Interim Auditing Standard AU 316, *Consideration of Fraud in a Financial Statement Audit*.

#### Incentives or pressures

Financial stability or profitability is threatened by economic, industry or entity operating conditions, such as (or as indicated by):

- ▶ A high degree of competition or market saturation, accompanied by declining margins
- ▶ High vulnerability to rapid changes, such as changes in technology and product obsolescence
- ▶ Significant declines in customer demand and increasing business failures in either the industry or overall economy
- ▶ High vulnerability to changes in interest rates
- ▶ Threat of imminent bankruptcy, foreclosure or hostile takeover
- ▶ Recurring negative cash flows from operations, or an inability to generate cash flows from operations while reporting earnings and earnings growth



- ▶ Unusually rapid growth or profitability, especially compared to that of other companies in the same industry
- ▶ New accounting, statutory or regulatory requirements that could impair the financial stability or profitability of the entity

Excessive pressure for management to meet third-party requirements or expectations can be due to:

- ▶ A failure to meet profitability or trend-level expectations of investment analysts, significant creditors or other external parties, particularly those expectations that are unduly aggressive or unrealistic, including expectations created by management, such as overly optimistic press releases or annual report messages
- ▶ Significant pressure to obtain additional debt or equity financing to stay competitive, including the need for funds to finance major research and development or capital expenditures
- ▶ High dependence on debt or marginal ability to meet exchange listing requirements, debt repayment requirements or debt covenants
- ▶ Adverse consequences for significant pending transactions, such as a business combination or contract award, if poor financial results are reported

Personal net worth of management or those charged with governance can be threatened by the entity's financial performance if:

- ▶ A significant concentration of their personal net worth is in the entity
- ▶ A significant portion of management compensation is contingent on the financial results of the entity, particularly when aggressive targets are set
- ▶ Management or a member of those charged with governance has personally guaranteed the debt of the entity

Management's financial interests in certain related parties may provide incentives for management to override controls by (1) directing the entity, against its interests, to make transactions for the benefit of these parties or (2) colluding with such parties or controlling their actions. Such frauds may include:

- ▶ Creating fictitious terms of transactions with related parties designed to misrepresent the business rationale of these transactions

- ▶ Fraudulently organizing the transfer of assets from or to management or others at amounts significantly above or below market value
- ▶ Engaging in complex transactions with related parties, such as special-purpose entities, that are structured to misrepresent the entity's financial position or performance

## Opportunities

The nature of the industry or the entity's operations may provide opportunities to engage in fraudulent financial reporting due to:

- ▶ Domination of a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's-length transactions
- ▶ Assets, liabilities, revenues or expenses based on significant estimates that involve subjective judgments or uncertainties that are difficult to corroborate
- ▶ Significant, unusual or highly complex transactions, especially those close to year-end, that pose difficult "substance over form" questions
- ▶ Significant operations located or conducted across international borders in jurisdictions with differing business environments and cultures
- ▶ The use of business intermediaries that appear to have no clear business justification
- ▶ Significant bank accounts, subsidiary operations or branch operations in tax-haven jurisdictions that appear to have no clear business justification

Management may be ineffective in its monitoring due to:

- ▶ Domination of management by a single person or small group, in a non-owner-managed business, without compensating controls
- ▶ Ineffective oversight over the financial reporting process and internal control by those charged with governance

The organizational structure may be too complex or unstable due to:

- ▶ Difficulty in determining which individuals have a controlling interest in the entity
- ▶ Overly complex organizational structure involving unusual legal entities or managerial lines of authority

- ▶ High turnover of senior management, legal counsel or those charged with governance

Internal controls may be deficient due to:

- ▶ Inadequate monitoring of controls, including automated controls and controls over interim financial reporting, where external reporting is required
- ▶ High turnover rates or employment of ineffective accounting, internal audit or IT staff
- ▶ Ineffective accounting and information systems, including situations involving significant deficiencies

### Attitudes

- ▶ Lack of support for the entity's values or ethical standards by management, or the communication of inappropriate values or ethical standards
- ▶ Excessive participation by non-financial management in the selection of accounting principles or the determination of significant estimates
- ▶ Known history of violations of securities laws or other laws and regulations by board members or senior management
- ▶ Claims against the entity, its senior management or board members alleging fraud or violations of laws and regulations
- ▶ Excessive interest by management in maintaining or increasing the entity's stock price or earnings trend
- ▶ A dispute between shareholders in a closely held entity
- ▶ Management committing to analysts, creditors and other third parties to achieve aggressive or unrealistic forecasts
- ▶ Management failing to correct known significant deficiencies in a timely manner
- ▶ Management employing inappropriate means to minimize reported earnings for tax-motivated reasons
- ▶ An owner-manager who makes no distinction between personal and business transactions
- ▶ Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality

- ▶ A strained relationship between management and the independent auditor, as exhibited by:

- ▶ Frequent disputes on accounting, auditing or reporting matters
- ▶ Unreasonable demands, such as excessive fee pressure, or unreasonable deadlines for completing the audit or issuing the independent auditor's report
- ▶ Formal or informal restrictions that inappropriately limit access to people or information or that hinder the ability to communicate effectively with those charged with governance
- ▶ Management's attempts to influence the scope of the accountant's work or the selection or continued assignment of audit personnel to the engagement ←

## Leading practices

### Managing fraud risks and factors

- ▶ Cultivate and demonstrate an honest and ethical corporate culture
- ▶ Be skeptical, inquisitive and diligent
- ▶ Understand fraud risks, including potential management override of controls and potential fraud related to revenue recognition
- ▶ Discuss fraud risks with other audit committee members
- ▶ Communicate with management and the auditors about fraud risks, known and suspected fraud, and controls to prevent and detect fraud

A blurred red train is moving through a station platform. The train is the dominant feature, with its motion creating horizontal streaks. The platform floor is light-colored with dark lines. A person's legs and feet are visible in the lower right, also blurred, suggesting they are standing on the platform. The background is dark, likely the tunnel or station interior.

**03**

# Making connections



# Audit committee organization and operation

Volatility and complexity are not going away. Boards and audit committees need to constantly challenge their processes and make sure they have the right competencies around the table.

## Committee charter

Both the NYSE and NASDAQ require their listed companies' audit committees to have charters, which can be modified as needed. The SEC also requires any public company to disclose in its proxy statement whether it has a written charter, and if so, whether the charter is listed on the company's website. Best practices for companies in this area would include performing an annual review of the charter to update it for changes in regulatory or legal requirements, bylaws or the reassignment of responsibilities.

→ For more information, see [Example audit committee charter](#) and [Example meeting planner](#) in Examples.

## Audit committee composition

The committee's composition is an important part of its effectiveness. The appropriate level of skill, commitment and availability of its members is critical to the committee's ability to perform its responsibilities effectively. A range of diverse perspectives and thinking helps strengthen the quality of audit committee deliberations and provides real value to companies and shareholders.

The audit committee must comprise at least three fully independent members. Audit committee members can be appointed by an independent nominating committee or by independent directors from the board. In addition, all members must be financially literate, and at least one member should be a financial expert with accounting or related financial management experience.

## Independence

Independence should be reviewed at least annually, but preferably more frequently, to identify changing relationships or circumstances that may affect independence as soon as possible. SOX Section 301 prohibits audit committee members from accepting any consulting or advisory fee from the issuer or any subsidiary, as well as from being otherwise affiliated with the issuer or subsidiary. Prohibited compensation can include indirect compensation to spouses, minority children or adult children who live with the committee member.

## Financial expertise

SOX Section 407 requires an issuer to disclose whether at least one financial expert is on the committee. A company that does not have an audit committee financial expert must disclose this fact and explain why it has no such expert. If the committee has a financial expert, the company must disclose the expert's name. The board of directors will make this determination, based on whether the individual has:

- ▶ An understanding of financial statements and US GAAP
- ▶ An ability to assess the general application of US GAAP for estimates, accruals and reserves
- ▶ Experience preparing, auditing, analyzing or evaluating financial statements of the same level of complexity as the issuer's financial statements, or experience actively supervising those who engaged in such activities
- ▶ An understanding of internal control over financial reporting
- ▶ An understanding of the audit committee's functions

These attributes can be obtained by:

- ▶ Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor, or experience in one or more positions that involve the performance of a similar function
- ▶ Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions
- ▶ Experience overseeing or assessing the performance of companies or public accountants in preparing, auditing or evaluating financial statements

→ For more information, see *Example audit committee financial expert questionnaire* in Examples.

## Performance evaluation and self-assessment

NYSE listing standards require audit committees to evaluate their own performance each year. They should use the evaluation process and results as a catalyst to improve their processes, procedures and agendas. This assessment should compare the committee's actual performance against both its charter and relevant peer groups. An independent party or the audit committee itself can conduct the performance review of the committee.

Some companies use a mix of internal and external representatives to perform this evaluation. For public companies, the view of the independent auditors is also helpful because the auditors are required to consider the audit committee's effectiveness during their evaluation of the control environment as part of Section 404 procedures.

In general, the audit committee needs to review its performance throughout the year to determine whether it met the objectives and responsibilities set forth in the charter. Some areas of focus could be:

- ▶ Audit committee composition, structure and activities
- ▶ How well it understands the business and its risks

- ▶ How it sets the tone with management, internal audit and independent auditors
- ▶ How well it understands and considers fraud risks, including the company's controls to mitigate such risks
- ▶ How well the committee oversees the company's financial reporting process
- ▶ How well it understands the company's internal control over financial reporting, including how it evaluates the effectiveness and conclusions of internal control, and whether the related disclosures are adequate

In addition, the audit committee chair could periodically review the performance of each committee member, assessing business knowledge, objectivity, independence, insight, judgment, communication skills and general dedication to the committee. The results could show that a committee member needs additional training or may need to be replaced. The audit committee should develop and execute an action plan to address any areas that need improvement. The committee chair should seek the advice of general counsel about what to document as a result of this evaluation.

→ For more information, see *Example audit committee self-assessment tool* in Examples.

## Executive sessions

Audit committees hold private sessions, often with internal audit, the independent auditor and management. Audit committee members may use this time to:

- ▶ Reflect on issues, evaluate what is working and not working, and identify follow-up actions
- ▶ Establish clear expectations of internal audit, the independent auditor and management
- ▶ Meet privately with various members of management, such as the CFO, controller, general counsel and others as appropriate
- ▶ Agree on clear objectives and expectations for each meeting
- ▶ Solicit thoughts on specific topics and questions
- ▶ Understand the response and resolution for issues raised

## Interaction with other board committees

The interplay between executive compensation policies and risk management has been a particular area of focus for regulators and investors. The audit committee also needs to evaluate potential areas of risk to the financial statements or the company's system of internal control.

While overseeing the assessment and disclosure of compensation-related risks is mainly the role of the compensation committee and the full board, the audit committee can help assess how the company's compensation plans employ certain financial metrics and how those may affect the company's fraud risks. It can also review the proxy statement, the compensation discussion and analysis, and other disclosures.

The audit committee should:

- ▶ Meet periodically with the compensation committee about management incentives and related topics
- ▶ Consider, with the compensation committee, the appropriateness of the incentive structure and whether it contributes to increased fraud risk
- ▶ Determine whether the company is appropriately focusing on the compensation of officers and directors, including the appropriate use of corporate assets, such as planes and apartments ↩

## Leading practices

### Audit committee organization and operation

- ▶ Focus on committee composition issues, including independence, financial expertise, broad business or leadership experience and succession planning
- ▶ Evaluate the expertise and competence of the members in the context of the company's strategy and risk profile today and for the next several years
- ▶ Consider the ability to work collectively, to challenge decisions in a credible manner and to avoid groupthink
- ▶ Help promote healthy skepticism among fellow committee and board members
- ▶ Consider periodically rotating audit committee members, staggering the terms of service to bring in new skills and perspectives
- ▶ Engage independent advisors as necessary
- ▶ Align audit committee meeting materials and agendas with priority areas
- ▶ Present compliance matters, standard reports and informational items at the end of advance material packages and meetings
- ▶ Follow meetings with private and executive sessions with independent auditors and the internal auditor
- ▶ Coordinate with the compensation committee to help assess how certain financial metrics are employed in the company's compensation plans and to review proxy statements



# Working with independent auditors

Overseeing the independent auditor is a key responsibility of the audit committee. The audit committee appoints the independent auditor, assesses its independence, discusses the audit scope and results and determines the independent auditor’s compensation. Candid and open communication between the independent auditor and audit committee is imperative for a successful relationship.

Audit committees play a critical role in overseeing the independent auditor and evaluating audit quality. In recent years, audit committees have become more engaged. They are evaluating audit and non-audit services with increased rigor, and they are asking their independent auditors probing questions and meeting with them more frequently. These meetings often include subject-matter experts.

Audit committees increasingly are evaluating the independent auditor’s performance. Audit committee chairs report that a vast majority of audit committee members discuss the independent auditor’s performance among themselves, and they meet with senior finance management and the internal auditor to discuss the audit firm’s performance.

## Inspection findings and quality control matters

The Center for Audit Quality has developed a Practice Aid that encourages all audit firms to proactively and robustly communicate with the audit committee any audit deficiencies identified by a PCAOB or internal inspection of the issuer’s audit engagement. According to the Practice Aid, the following communications should be made to the audit committee:

- ▶ Whether the issuer’s audit was selected for inspection by the PCAOB, and if so, the status of that inspection’s progress

- ▶ The PCAOB’s risk-based approach for selecting engagements and its areas of audit focus
- ▶ The nature of any inspection findings, including the audit procedures considered to be either omitted or insufficient. For example, audit committees should be informed:
  - ▶ If the PCAOB informs the audit firm that an audit opinion on the issuer’s financial statements or internal control over financial reporting may not be sufficiently supported
  - ▶ If the PCAOB informs the audit firm that the financial statements may contain a material misstatement or an inadequate disclosure
  - ▶ If the PCAOB informs the audit firm of a concern with the adequacy or effectiveness of the issuer’s internal control over financial reporting
  - ▶ If the PCAOB informs the audit firm that the audit firm’s independence may have been impaired relative to the issue
- ▶ Whether any common findings exist in the results of the internal or PCAOB inspections that would be relevant to the issuer’s financial statements
- ▶ The steps the audit firm is taking to rectify any of the quality control issues identified in the PCAOB report
- ▶ Whether any matters addressed in PCAOB 4010 reports relate to the issuer and what policies or procedures are being introduced to address such matters

## Increased engagement

To improve oversight of the audit process, audit committees generally do not limit their interactions with the independent auditor to formal audit committee meetings. Instead, they often arrange meetings throughout the year to encourage candid and open communication and information flow between the auditor and audit committee. Increasingly, audit committee chairs are meeting with the lead audit partner between meetings, or before each meeting, to better understand the most important issues.

Audit committee chairs are routinely providing formal and informal feedback to auditors to improve the audit process and the transparency of two-way communication between audit committees and auditors.

## Matters for consideration regarding audit scope

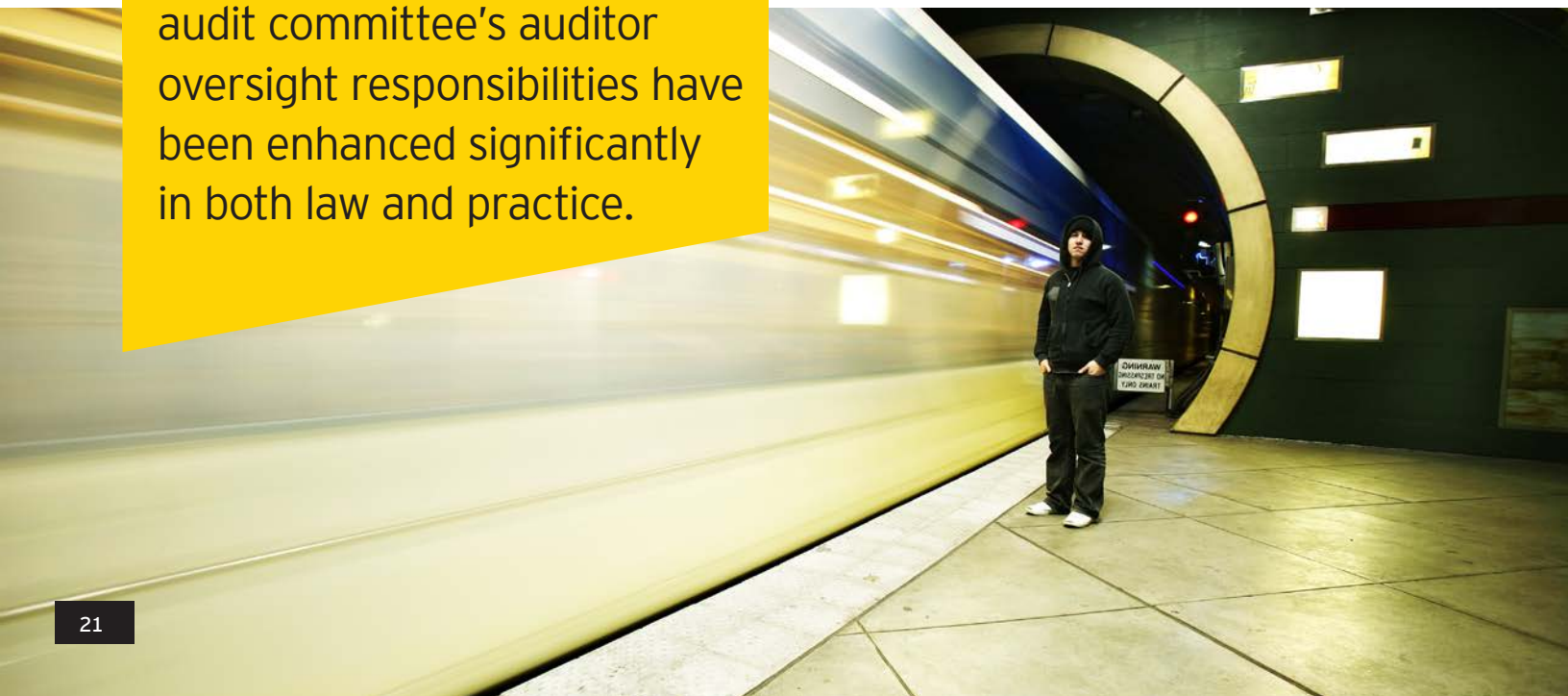
Independent auditors determine the audit scope and discuss the scope with the audit committee. This discussion allows the audit committee to be sure that the audit scope has not been affected by pressures from management. Audit committees also can ask independent auditors to perform more work in certain areas where they may have additional concerns.

Under the requirements of the Act, audit committees are directly responsible for the appointment, compensation and oversight of the auditor. Compensation (i.e., fees) is directly linked to the scope of the audit.

→ For more information about communication of audit results, see *Communication between the independent auditor and the audit committee* on page 3.

→ See questions in the *Independent auditor* section on page 41.

Since Sarbanes-Oxley, the audit committee's auditor oversight responsibilities have been enhanced significantly in both law and practice.



## Annual evaluation of the independent auditor

Each year, the audit committee should evaluate the independent auditor to make an informed decision regarding whether to retain the auditor. The evaluation should encompass an assessment of the auditor’s qualifications and performance; the quality and candor of the auditor’s communications with the audit committee and the company; and the auditor’s independence, objectivity and professional skepticism.

The annual auditor assessment should draw on the audit committee’s experience with the auditor during the current engagement (presentations; reports; dialogue during formal, ad hoc and executive sessions), as informed by prior-year evaluations. It is appropriate to obtain observations on the auditor from others within the company, including management and internal audit, accompanied by discussions with key managers.

Audit committee members should evaluate the auditor’s performance throughout the audit process, noting such items as the auditor’s skepticism in evaluating unusual transactions or responsiveness to issues. These contemporaneous assessments provide important input into the annual evaluation process.

Audit committees also should consider advising shareholders that they perform an annual evaluation of the auditor and explain the process and scope of their assessment.

In late 2012, the Center for Audit Quality along with several other organizations released a tool to assist audit committees in their evaluation of the independent auditor. The tool includes sample questions, including those designed to assess the independent auditor’s quality of service, communication and independence. 📄

➔ For more information, see *Example annual evaluation of the independent auditor* in Examples.

## Leading practices

### Working with independent auditors

- ▶ Exercise ownership of the relationship with the independent auditor
- ▶ Get to know the lead partners and meet with them periodically
- ▶ Establish expectations about the nature and method of communication, as well as the exchange of insights
- ▶ Review the proposed audit plan and scope of work
- ▶ Engage in regular dialogue outside the scheduled meetings
- ▶ Set an annual agenda with the independent auditor
- ▶ Focus on independence, including a preapproval process
- ▶ Consider the findings from the financial statement audit and make sure management responds to the findings
- ▶ Discuss with the auditors their views regarding the company’s internal controls over financial reporting
- ▶ Seek the auditor’s views on the effectiveness of the company’s governance process
- ▶ Provide formal evaluations of the auditor as well as regular feedback



# Working with the internal auditors, CFO and the general counsel

As audit committees take on increasing responsibilities, many are interacting with the company’s internal auditors much more frequently, whether in relation to internal controls, compliance matters, whistleblower hotlines or other matters.

As a result, the detail and frequency of the internal auditor reporting to the audit committee have increased at many companies over the past several years.

Audit committees rely heavily on management and therefore need an open and effective relationship. The committee should meet with the finance department, the general counsel and compliance, risk and ethics officers. Many audit committees are expanding these lines of communication to include business unit leaders, treasury and tax functions and the chief information officer (CIO).

Audit committees should be able to ask members of management difficult questions. If management appears unresponsive or evasive, this could be a red flag.

## Working with the internal auditor

An effective internal audit function can be a powerful safeguard against defects in financial controls or financial statements. For example, in the case of WorldCom, the whistle-blower was a member of WorldCom’s internal audit department.

A strong, well-performing internal audit function may also help facilitate the independent auditor’s audit in certain areas.

When a company outsources the internal audit function to a third-party service provider, regular interaction between the audit committee and the internal auditor is critical to the effective functioning of the internal audit group. The audit committee should take care to determine that appropriate collaboration and communication occur.

The audit committee should meet regularly and privately with the internal auditor and make sure that the internal auditor has direct access to the audit committee. An audit committee also should be comfortable that the internal audit staff has the appropriate training and supervision to stay professionally current.

## Working with the CFO

The CFO plays an important role in the financial reporting process and can keep the lines of communication open by preparing a list of new disclosures for the audit committee and the disclosure committee. The CFO also can coordinate appropriate meetings with the independent auditor and the audit committee to review the risks to which the company is exposed.

At some companies, controllers create a summary review document describing the critical accounting estimates used in the financial statements. The CFO reviews the summary and provides it to the audit committee before each quarterly meeting. The objective is to help focus the audit committee's attention on the significant risks (specifically, financial reporting risks) the company faces.

→ For more information, see questions in the *Internal auditor* section on page 40.

## Succession planning

Inadequate succession planning for the CFO can lead to prolonged and expensive executive searches, downward pressure on stock prices, loss of strategic momentum and investor confidence, and a successor who is out of step with the company's strategy and culture.

The SEC called succession planning "one of the board's key functions," critical to preventing the company from being "adversely affected due to a vacancy in leadership." The SEC deemed succession planning to be a risk management issue – a critical development for audit and risk committees – and recognized succession planning as an appropriate subject for shareholder proposals.

## Working with the general counsel

The audit committee's relationship with the company's general counsel is evolving. Audit committees and boards increasingly are looking to the general counsel not only for legal advice, but also for business advice. And as a corporate leader, the general counsel helps to set the organization's tone and culture.

The general counsel can help the company better understand its disclosure obligations under the SEC statutes, and it can help to prepare for an investigation. The SEC's whistle-blower bounty program and stepped-up enforcement of the FCPA are making "investigation readiness" an important priority. General counsels

play a pivotal role here, helping the audit committee to determine the criteria for bringing matters to the attention of the full board and whether outside counsel or advisors are needed.

As audit committees wrestle with heavy agendas and information overload, general counsels – working with the CFO – can help bring more discipline and focus to the agenda-setting process and support the timeliness and quality of meeting materials. ←

# Leading practices

## Working with the CFO, internal auditors and the general counsel

- ▶ Focus on the tone at the top, culture, ethics and hotline monitoring
- ▶ Work with management to anticipate and identify emerging issues
- ▶ Provide input to management's goal setting
- ▶ Discuss succession planning for the CFO and staff
- ▶ Determine whether the internal auditors have a direct functional reporting line to the audit committee and an indirect line to management for administrative activities
- ▶ Be involved with the internal audit risk assessment and audit plans, including activities and objectives regarding SOX Section 404 compliance
- ▶ Conduct annual evaluations assessing management's competency and integrity, as well as the effectiveness and competence of the internal audit department
- ▶ Understand whether the internal audit department is viewed as objective and competent by the independent auditors
- ▶ Establish how the internal audit function relates to other risk-related functions, such as legal, security, environmental health and safety, compliance and credit risks, considering duplication of efforts or gaps between these functions



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The audit committee should meet regularly and privately with the internal auditor and make sure that the internal auditor has direct access to the audit committee.





04

Resources  
for your  
journey

# Training and education

Audit committee members, particularly those new to the committee, need sufficient training and education to fulfill their responsibilities. At a minimum, the education programs should provide an overview of the company, cover the role of the audit committee and convey the expected time commitment of the position. Any new audit committee member also should meet with senior management, controllers, business unit leaders, internal audit, external audit and other committee members.

## Background information for new committee members

Before their first meeting, new audit committee members should understand:

- ▶ The audit committee's requirements and objectives and the timing of reporting requirements
- ▶ The company's business and its industry
- ▶ The company's products and services
- ▶ The internal control (including key risks) and financial reporting process
- ▶ Key accounting policies and any principles and practices unique to the company's industry
- ▶ Pending litigation or contingencies
- ▶ Internal audit's responsibilities and background
- ▶ The scope of the current-year external audit and the timing of reports issued
- ▶ Management's background, reporting structure and responsibilities

New audit committee members should also review the charter and recent audit committee meeting minutes.

Training for audit committee members is critical, enabling them to understand their responsibilities and perform their tasks appropriately.

## Ongoing training and education

Because audit committee members are expected to be financially literate, it is important for them to keep abreast of accounting and financial reporting developments, as well as any regulatory changes.

Committee members can educate themselves by enrolling in external courses and seminars, as well as by interacting with management, internal auditors, independent auditors and other directors. They should also stay informed through their own independent reading and by keeping up with business news. In addition, more and more companies are inviting subject-matter specialists to give presentations at audit committee meetings, allowing members to keep up on current topics.

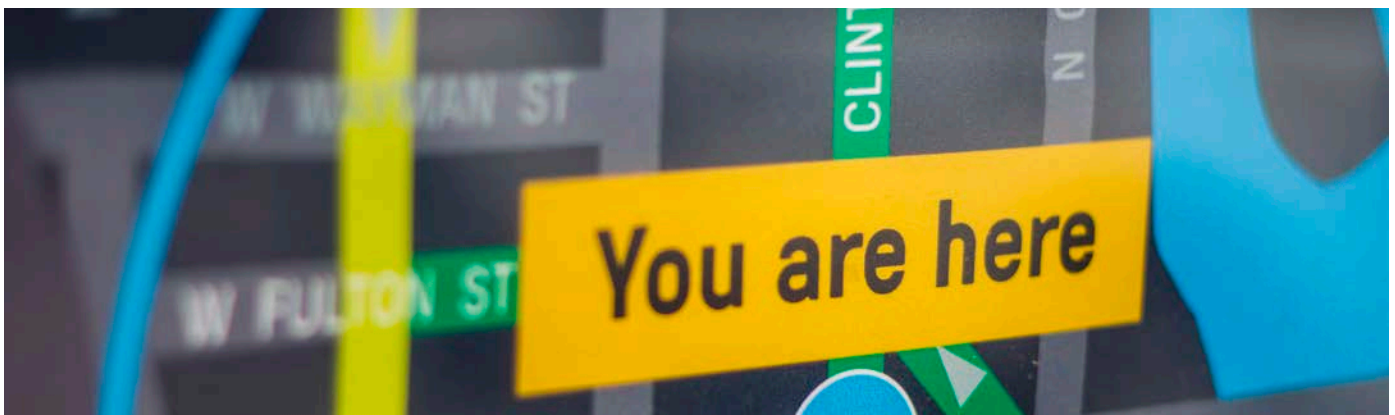
Some areas of focused training could be:

- ▶ Accounting and financial reporting developments
- ▶ The business environment
- ▶ Key information systems, processes and controls
- ▶ Enterprise risk management processes
- ▶ Specific risk areas
- ▶ Corporate governance
- ▶ Emerging audit committee responsibilities
- ▶ Legal developments

## Leading practices

### Training and education

- ▶ Make sure that board education as described in the company's corporate governance guidelines is consistent with NYSE listing standards
- ▶ Provide orientation for new audit committee members
- ▶ Consider offering continuing education in specialized or regulated industry matters, industry trends, reporting, operations and regulated topics
- ▶ Consider customized programs of continuing education that address topics relevant to the committee's needs and incorporate company-specific processes and objectives
- ▶ Offer one-on-one and committee-level education





# References and suggested reading

## Center for Audit Quality

[www.thecaq.org](http://www.thecaq.org)

The Center is an autonomous, nonpartisan, nonprofit group based in Washington, DC. It is governed by a Board that comprises leaders from the public company auditing firms, the American Institute of CPAs and three members from outside the public company auditing profession.

## Conference Board

[www.conference-board.com](http://www.conference-board.com)

The Conference Board is a global, independent membership organization that conducts research, convenes conferences, makes forecasts, assesses trends, publishes information and analysis, and brings executives together to share insights.

## Corporate Board Member

[www.boardmember.com](http://www.boardmember.com)

Corporate Board Member, an NYSE Euronext company, is an information and education resource for senior officers and directors of publicly traded corporations, large private companies and Global 1000 firms. Their Resource Center offers complete issues of *Corporate Board Member* magazine, as well as additional articles, webcasts and interviews.

## EY AccountingLink

[www.ey.com/us/accountinglink](http://www.ey.com/us/accountinglink)

We provide technical guidance and our analysis of the effect of proposed and final guidance from standard setters. First-time users will be prompted to register.

## EY audit committee resources

[www.ey.com/auditcommittee](http://www.ey.com/auditcommittee)

Access our quarterly audit committee publication, *BoardMatters Quarterly*, as well as information on current topics and developments affecting audit committees. You can also register to receive future audit committee insights from EY.

## National Association of Corporate Directors

[www.nacdonline.org](http://www.nacdonline.org)

The National Association of Corporate Directors (NACD) is an educational, publishing and consulting organization in board leadership. The NACD promotes high professional board standards, creates forums for peer interaction, enhances director effectiveness, asserts the policy interests of directors, conducts research and educates boards and directors concerning traditional and cutting-edge issues.

## Society of Corporate Secretaries and Governance Professionals

[www.governanceprofessionals.org](http://www.governanceprofessionals.org)

The Society of Corporate Secretaries and Governance Professionals seeks to be a positive force for responsible corporate governance, providing news, research and “best practice” advice and offering professional development and education through seminars and conferences.

## Stock exchange requirements

[NYSE \(Sections 303A.06 and 303A.07\)](#)

[NASDAQ \(Rule 5600\)](#)

Audit committee governance requirements are included within the NYSE and the NASDAQ stock exchange company listed manuals. Refer to the links above for additional information on these requirements.

## The Committee of Sponsoring Organizations of the Treadway Commission

[www.coso.org](http://www.coso.org)

The Committee of Sponsoring Organizations of the Treadway Commission is a joint initiative of five private sector organizations and is dedicated to providing thought leadership through the development of frameworks and guidance on enterprise risk management, internal control and fraud deterrence. ←



# Questions

for the audit committee  
to consider

- ▶ Financial reporting
- ▶ Internal controls
- ▶ Internal auditor
- ▶ Independent auditor

# Financial reporting

## General

- ▶ If there was any significant change in the business environment, such as new competition or a change in regulation, how did this change affect judgments and estimates; recoverability of assets, including fixed assets, intangible assets, goodwill and investments; and potential classification issues, such as classification of debt?
- ▶ Has there been a voluntary change in accounting principles, such as a change in inventory method from last-in, first-out (LIFO) to first-in, first-out (FIFO)? If so, how did the company decide that this policy was preferable, and will a preferability letter from the auditors be filed with the financial statements? Are there longer-term effects expected from the change?
- ▶ Has there been any significant change in accounting estimates during the period? Have there been any significant changes in trends or facts that may indicate estimates should change, such as changes in frequency or cost of warranties, technology changes or an estimated settlement of contingencies? Have there been any changes in the company's methods for determining significant accounting estimates, or were there significant changes in the nature of the assumptions used during the period?
- ▶ Has the company received any SEC comment letters during the period? If so, what was the focus of these letters? Has management made any changes to the financial statements as a result? Are there any unresolved matters?
  - ▶ Did the company receive a comment letter from the SEC regarding its filings? Were any significant issues raised?
  - ▶ Were the independent auditors involved in assisting management draft responses? Were their suggestions accepted by management?
  - ▶ Are there any outstanding comment letter issues?
  - ▶ Did a restatement of financial statements result from the SEC comment process?
- ▶ Did the company have any accounting or financial reporting issues for which it sought pre-clearance of the matter from the SEC?
- ▶ Were any new accounting standards adopted during the year? If so, what was the effect on the financial statements? Does the new standard require any new significant judgments or estimates?
- ▶ If there was a significant operational issue during the period, such as excessive downtime or rework, how did management consider the following, and what were the results:
  - ▶ Contractual disputes and potential effects on accounting, such as revenue recognition and contingent liabilities
  - ▶ Appropriateness of inventory valuation, such as whether abnormal costs were expensed
  - ▶ Impairment of assets
- ▶ Have there been any new or significant changes in contractual agreements that could have an effect on the accounting treatment (e.g., revenue recognition, inventory)? Examples include:
  - ▶ Consignment arrangements
  - ▶ Bill and hold arrangements
  - ▶ Change in shipping terms
  - ▶ Product financing
- ▶ Have the stringent requirements for bill and hold revenue been met?
- ▶ If there was a significant change in the company's organization during the period, did management consider if financial reporting was affected? Examples include:
  - ▶ Discontinued operations
  - ▶ Change in segments
  - ▶ Exit or disposal obligations, such as contract termination costs or involuntary employee termination benefits under the terms of a one-time benefit



- ▶ Changes to the company's system of internal controls
- ▶ Consolidation
- ▶ Has the company continually evaluated its segment reporting?
- ▶ As part of management's execution of its business plans, did it consider any financial reporting implications, and if so, what was its conclusion? Examples include:
  - ▶ Significant property, plant and equipment expenditures, including potential asset valuation issues or contractual issues with vendors
  - ▶ Business acquisitions
- ▶ Were any known errors not recorded? Why were these not recorded? What did management do to assess materiality? Did management consider any control implications for these errors?
- ▶ Were any significant deficiencies or material weaknesses identified? If so, how did these arise, and what is the plan to remediate them?
- ▶ Have there been any significant subsequent events (i.e., transactions or events that occur after the balance sheet date but before financial statements are issued or are available to be issued)? If so, how have they been recognized in the financial statements (where applicable) or disclosed in the footnotes?
- ▶ Has the company disclosed risks and uncertainties that in the near term – within one year from the date of the financial statements – could significantly affect the amounts reported in the financial statements?
- ▶ Is the company able to meet obligations as they become due without substantial disposition of assets outside the ordinary course of business, restructuring of debt or equity, or operational improvements, whether these improvements are the result of a change in the company's operating environment or the result of regulatory forbearance?
- ▶ Has the company appropriately considered whether conditions or events exist that raise doubts about the company's ability to continue as a going concern?
- ▶ Have there been any significant fluctuations in results from year to year, or between actual and budgeted results?
- ▶ How do the company's accounting policies compare to leading practices in the industry?
- ▶ Does the MD&A adequately explain the company's financial condition and results of operations?
- ▶ What recommendations have the independent auditors made relating to the financial reporting process? How has management responded?
- ▶ Have there been any disagreements between management and the independent auditors on accounting principles or how to account for a significant transaction?
- ▶ Has the independent auditor consulted with its national office on significant issues? If so, what were the issues?

## Cash

- ▶ Are there any restrictions on the use of cash? If so, are they properly disclosed?
- ▶ Is any portion of the cash balance held under formal or informal compensating balance arrangements? If so, are these facts disclosed in the financial statements?
- ▶ Is the presentation of the statement of cash flows consistent with previous years? Were there any significant cash transactions where management had difficulty identifying the appropriate classification (e.g., operating versus financing activities) on the statement of cash flows?
- ▶ What is the company's policy for including financial instruments within cash equivalents? Does the company appropriately consider Accounting Standards Codification (ASC) 820-10, *Fair Value Measurement*, when valuing such instruments?
- ▶ For significant cash in foreign locations, is appropriate disclosure provided?
- ▶ For new or unusual items, has the cash flow presentation been fully evaluated?

## Financial instruments

- ▶ How does the company invest excess funds? What are the investment policies on risk and yield?
- ▶ Have there been significant changes during the year in the types of investments held?
- ▶ Has the company invested in any “exotic” or unusual financial instruments?
- ▶ Does the company hold any significant investments in sovereign debt issued by European countries that are experiencing liquidity issues, such as Greece? If so, has the company considered any concentrations of credit risk for disclosure?
- ▶ Has the company entered into any interest rate contracts; foreign currency contracts or other types of options, futures, forwards or swap contracts; or any other types of derivatives? How are they disclosed in the financial statements? If so, what is the nature and extent of the use of derivatives? What are the company’s policies and procedures related to entering into these agreements and evaluating them?
- ▶ For derivatives, are related gains and losses properly classified, described and disclosed in the financial statements?
- ▶ Does the company use derivatives as a hedging instrument and intend for these hedging relationships to qualify for hedge accounting? If so, has the company documented its hedges, and are the periodic assessments of ongoing effectiveness, as required by US GAAP, being performed?
- ▶ Has the company considered the counterparty’s credit risk, as well as its own credit risk, when determining fair value of its derivative instruments?
- ▶ Does the company have any intercompany loans between entities with different functional currencies for which changes in exchange rates are reported in consolidated other comprehensive income? If so, has the company performed sufficient analysis to determine whether such loans qualify for long-term investment treatment? Independent of the consolidated financial statement treatment, are the foreign currency remeasurement gains and losses on such loans properly recorded through income on any stand-alone financial statements for the borrowing and lending entities?
- ▶ How are debt and equity securities classified: held to maturity, trading or available for sale?
- ▶ How was fair value determined for financial instruments that did not have a readily determinable market value? If third-party pricing services were used to help establish these values, what has management done to understand how those prices were developed?
- ▶ Have “other than temporary” declines in value been considered?
- ▶ Are there any liens, pledges or other security interests in financial instruments? If so, are they properly disclosed? Are any contingent liabilities resulting from these transactions appropriately disclosed?
- ▶ Has the company issued convertible debt or convertible preferred shares? If so, has the company evaluated whether such a conversion feature requires separate accounting recognition?
- ▶ Does the company have freestanding equity derivative instruments – written call options (warrants), written put options, purchased call options, purchased put options, forward share repurchase agreements or forward sale contracts? If so, has the company appropriately considered whether they should be classified in equity or as assets/liabilities?
- ▶ When using broker quotes or third-party pricing services to estimate the fair value for different financial instruments, how does the company validate these prices or quotes?

## Accounts receivable/loans

- ▶ How many days’ sales are included in receivables at year-end? How does this number compare to the prior year?
- ▶ Are any significant or unusual amounts due from related parties, including officers and employees? How do these amounts compare to the prior year?
- ▶ What is the amount of bad debt expense this year? How does it compare to the prior year?

- ▶ How was the allowance for doubtful accounts/loan loss reserves determined? Has there been a change in the methodology or assumptions used in determining the allowance for doubtful accounts/loan loss reserves? If so, why? How was its adequacy evaluated? Has the allowance changed from the prior year in proportion to changes in receivables/loans? If not, why not?
- ▶ Is there a high concentration of credit risk (e.g., industry, geographic area, sole debtor)?
- ▶ Are there any significant receivables from European governments experiencing liquidity issues? Has the aging of these receivables deteriorated during the year? Are there any plans to accept bonds or other long-term obligations of these governments in satisfaction of the receivables?
- ▶ What were the largest accounts or loans charged off this year? Were they reserved at the prior year-end? If not, why not?
- ▶ Does the company participate in loans or syndications originated by others? If so, what type of independent credit analysis is performed?
- ▶ Has there been an increase in identified troubled debt restructurings? What types of modifications, concessions or other arrangements is the company providing to its customers? What factors are considered by the company when determining whether to provide customers with payment delays?
- ▶ What procedures were performed to make sure that inventory was not overstated by including obsolete or excess stock? What steps were taken to identify obsolete and excess inventory that require provision? How was the provision for obsolete and excess inventory evaluated for adequacy? Were there any significant write-downs?
- ▶ Was an evaluation performed to determine that inventory is properly recorded at the lower of cost or market?
- ▶ Are materials and supplies inventories appropriately accounted for? Should significant items that will not be sold be considered for reclassification?

## Inventories

- ▶ What accounting method is used to value inventory (e.g., FIFO, LIFO)? Does the company use standard costing? Were all variances analyzed and properly adjusted? When and where were physical inventories taken? Was the book to physical inventory adjustment significant? If so, why? How does the amount of the adjustment compare to the amount at the last physical inventory date?
- ▶ What procedures were performed with respect to off-site inventories?
- ▶ What cutoff procedures are in place for accounting for the shipping and receiving of inventories at period-end?

## Investments in affiliated entities

- ▶ Does the company have any subsidiaries accounted for by the equity method? If so, why is this method used, as opposed to consolidation, and is it appropriate?
- ▶ Has the company appropriately accounted for any investments in partnerships, joint ventures or other affiliated entities?
- ▶ Are there any variable interest entities (VIEs) that require consolidation by the company? Have the company's relationships with VIEs been properly disclosed, even if a VIE is not consolidated?
- ▶ Were financial statement reviews performed for entities in which the company is invested? What procedures were performed to substantiate the valuation of the investments?
- ▶ Have all intercompany transactions been eliminated in consolidation, as appropriate?

## Property, plant and equipment

- ▶ Are the estimated useful lives and methods of depreciation reasonable for property, plant and equipment? Have any of the estimated useful lives or methods changed from the prior year?
- ▶ Were there any significant new leases during the period? Did any require treatment as capital leases?



- ▶ How does the company account for leasehold improvements? How does it identify the appropriate period over which to amortize the costs of leasehold improvements?
- ▶ Did management capitalize any costs associated with material projects during the year? If so, what was the nature of such costs?
- ▶ Were there any indicators of impairment during the period? If so, how were these potential impairments evaluated, and what were the results? For example, did the indicated value only slightly exceed the carrying amount of the asset?
- ▶ Did management assess current-year activity (e.g., purchases of property, plant and equipment; entering into new leases; changes in laws, regulations or contracts) for any new asset retirement obligations? Did management assess for significant changes in estimates, such as for expected amounts or timing, for existing asset retirement obligations?
- ▶ Have any assets remained as in process for an extended period?
- ▶ What analysis did management perform to determine whether any assets should be classified as held for sale? If assets are classified for sale, were impairment and discontinued operations classification considered? If so, what was management's conclusion?

## Other assets

- ▶ What is included in other assets? Is the classification as short or longer term appropriate?
- ▶ As with property, plant and equipment, were there any indicators of intangible asset impairment? If so, how were they evaluated, and what were the results?
- ▶ Are the carrying amounts of goodwill reviewed at least annually to determine whether there has been an impairment in value? How are these carrying amounts evaluated? Are there any deferred charges? If so, have they been evaluated for recoverability?

## Current and non-current liabilities

- ▶ What procedures were performed to determine that there are no significant unrecorded liabilities?
- ▶ Are there any significant, unusual accruals? What significant year-end accruals have been recorded as part of the close process?
- ▶ Has the company modified, converted or extinguished outstanding debt during the year? If so, how did the company determine whether the transaction should be considered a modification or extinguishment of the original debt instrument for accounting purposes? Has the company considered whether the transaction would qualify as a troubled debt restructuring?
- ▶ Is the company in compliance with the provisions of its loan and debt agreements? Is the company in danger of not complying with such agreements during the next year?
- ▶ Has the company considered the proper classification of debt as current or non-current, particularly when considering covenant violations, covenant waivers and grace periods?
- ▶ What assets are pledged to secure borrowings? Have pledged assets been disclosed appropriately in the financial statements?
- ▶ Has the company issued guarantees of the debt of others? If so, are these guarantees properly disclosed in the financial statements?
- ▶ Has the company considered the necessity for, or adequacy of, environmental remediation liabilities?
- ▶ Are the assumptions used to value the pension benefit and other post-employment benefit obligations reasonable? Were there any changes in the assumptions this year as compared to last year? Were there any plan amendments during the last year?
- ▶ Have guarantor financial disclosures been properly considered?

## Contingencies

- ▶ Were any significant issues raised by legal counsel about litigation, contingencies, claims or assessments? If so, how have these matters been reflected in the financial statements or footnote disclosures?
- ▶ Were any commitments or loss contingencies indicating the potential incurrence of a liability or the possible impairment of an asset not provided for or disclosed in the financial statements? If these matters were not recognized or disclosed because the probable or reasonably possible losses could not be estimated, did the company disclose that such an estimate could not be made?
- ▶ What is the company's process for determining whether a range of loss can be reasonably estimated? Does the company reassess whether a range of loss can be reasonably estimated each reporting period?
- ▶ Have disclosures related to loss contingencies evolved over time to include more quantitative information as the loss contingency progresses?
- ▶ Where applicable, has the company disclosed the amount of exposure above the accrued amount that is reasonably possible of occurring (i.e., where the estimated loss is a range and the company has accrued the low point on the range)?
- ▶ Did management identify any other contingencies that require accrual or disclosure, such as product recalls or environmental obligations?
- ▶ Were the legal letters requested by the independent auditor received from all appropriate attorneys?

## Shareholders' equity

- ▶ Are any of the company's equity instruments mandatorily redeemable or redeemable at the option of the holder? If so, has the company evaluated whether those instruments should be classified outside of permanent equity?
- ▶ Does the company have any non-controlling interest that is redeemable outside of the company's control? If so, has the company evaluated whether those interests should be classified outside of permanent equity?

- ▶ Are there any restrictions on the use of the retained earnings of either the parent or its subsidiaries?
- ▶ Are there any restrictions due to the issuance of preferred stock or on the purchase or use of treasury stock?
- ▶ Does the company's state of incorporation allow for treasury stock presentation, or is repurchased stock deemed retired?

## Revenue and expenses

- ▶ How does the company's revenue recognition policy compare with those of other companies in the same industry? Has the company's policy changed in the current year? Has the company entered into new lines of business or product sales that require it to reconsider its existing revenue recognition policies?
- ▶ Has the company properly disclosed its policies relating to different classes of revenue transactions?
- ▶ What are the company's terms of sale and warranty policies? Have they changed from the prior year? If so, how?
- ▶ Has the gross profit percentage changed significantly from the prior year or during the year? If so, why?
- ▶ Are any unusual or nonrecurring items of revenue or expense included in the financial statements?
- ▶ What analyses have management and the auditors performed to consider whether complex revenue recognition issues, such as multiple element arrangements, exist and how to properly account for them?
- ▶ Do any industry-specific accounting principles apply to the company? If so, how do they differ from the general revenue recognition principles?
- ▶ How has management considered how the company may be affected by the proposed new revenue recognition guidance?
- ▶ How does the company account for rent expense relating to operating leases, including leases with option periods and escalating rent?
- ▶ Have website development costs been appropriately accounted for?
- ▶ How have loss contingencies been accounted for? How have they been disclosed?

- ▶ Has the company properly accounted for stock-based compensation? What are the significant assumptions used by management to estimate the fair value of stock options granted?
- ▶ Has the company modified any share-based payment arrangements during the year? If so, how do those modifications affect the compensation cost recorded on the financial statements?
- ▶ Has the company entered into any new employment contracts with key executives? If so, how has the company accounted for changes to executive compensation arrangements?
- ▶ Have the company's earnings-per-share calculations given effect to recent capital transactions or employment contracts that may involve dilutive securities?
- ▶ Has the company reconciled its deferred tax accounts to supporting records? Has the company prepared a tax-basis balance sheet to identify all temporary differences?
- ▶ Have significant deferred tax assets been recognized for which the realization is supported by expectations of future taxable income? If so, are the company's expectations of future taxable income reasonable and consistent with other forecasts provided to analysts and discussed in the MD&A (especially where the company has recognized recurring losses or experienced a significant loss in the current year)?
- ▶ Has the company reported losses from continuing operations and income from another source (e.g., discontinued operations, other comprehensive income, extraordinary items)? If so, were the intra-period tax allocation provisions of ASC 740 applied to benefit the loss from continuing operations?

## Income taxes

- ▶ Is there an unusual relationship between income before taxes and income tax expense? If so, what caused the unusual relationship, and have significant reconciling items been disclosed?
- ▶ What is the effective tax rate this year, and how does it compare to the prior-year rate?
- ▶ Does the company have significant earnings in foreign jurisdictions with low tax rates? If so, has the company disclosed the effect of such earnings on the effective tax rate?
- ▶ Has the company asserted that foreign earnings are indefinitely reinvested? If so, has the company considered the effect that such an assertion could have on liquidity (e.g., where the majority of cash is held by foreign subsidiaries and repatriation would result in significant income tax implications)?
- ▶ Have there been any changes in tax laws, rates or methods? If so, how have they been recognized in the financial statements?
- ▶ Has the company recorded a liability for uncertain income tax positions based on the recognition and measurement criteria described in ASC 740-10 (formerly FIN 48)?
- ▶ What is the company's process for identifying uncertain tax positions? How does the company evaluate and continually reassess the likelihood that these positions will be sustained by the taxing authority?

## Related parties

- ▶ Are there significant transactions with related parties? What was done to determine that they are appropriate, properly accounted for and adequately disclosed in the financial statements?
- ▶ If other auditors have been involved in the audit of the financial statements, what communication has taken place to determine that all significant transactions with related parties are identified?
- ▶ Are the disclosures in the financial statements regarding related parties complete and accurate?

## Structured transactions (including those involving special-purpose entities)

- ▶ What is the business purpose of the structured transaction?
- ▶ Can the structured transaction be understood and explained by management?
- ▶ What were the accounting implications of the transaction?
- ▶ Does the disclosure of the structured transaction include information critical to investors' understanding of the transaction's business purpose and economics?



# Internal controls

## General

- ▶ What are management's processes and criteria for evaluating identified deficiencies for significance, including significant deficiencies and material weaknesses?
  - ▶ Is the segregation of duties adequate? Is it prohibited for one person to both initiate and approve transactions? If not, what steps are taken to enhance the segregation of duties?
  - ▶ Has the company performed a fraud risk assessment? What fraud risks were identified as a result of the assessment? What are the company's antifraud programs and controls to mitigate the identified fraud risks?
  - ▶ Does the company have a formal code of conduct?
  - ▶ Are there adequate controls over the approval and monitoring of special transactions, such as related-party transactions, securitizations using special-purpose entities and other structured transactions?
  - ▶ How is the company using the internet for e-commerce and communications? Has management assessed the adequacy of controls related to this technology, including the security, privacy, confidentiality and reliability of information, as well as the systems supporting it?
  - ▶ Does the company have an appropriate business continuity plan, and if so, has that plan been tested recently?
  - ▶ Are review-level controls sufficiently precise to identify errors of importance?
  - ▶ How does the company evaluate and test controls over electronic evidence (including spreadsheets)?
- Have specific areas been identified where the independent auditor intends to use the work of management and internal audit as part of the audit of internal control?
- ▶ How will the locations to visit for the audit of internal control over financial reporting be selected, and how does that selection process differ from the audit of financial statements?
  - ▶ What percentage of total assets, revenue and pretax income will be obtained from the locations selected for testing in the audit of internal control over financial reporting?
  - ▶ Will any operations be excluded from the internal control assessment?
  - ▶ How will control deficiencies and planned corrective actions be tracked, evaluated and communicated to the audit committee?
  - ▶ How will IT-dependent controls be assessed for effectiveness?
  - ▶ What is the scope of IT general controls that will be included in the audit of internal control over financial reporting?
  - ▶ How will the independent auditor's assessment consider and evaluate controls over critical accounting estimates and judgmental areas?
  - ▶ What specialists will be involved in evaluating controls over complex, judgmental and IT-dependent processes?
  - ▶ How will the controls over accounting systems that have been outsourced to a third party be tested?
  - ▶ What are the most important changes to internal control the company needs to make in the future?
  - ▶ How does the company ensure that all electronic audit evidence has been identified and how do they evaluate and test the governing controls for electronic audit evidence, including spreadsheets?
  - ▶ Have there been any significant changes to the IT environment – system implementations, implementation of other emerging technologies (e.g., cloud). If so, how will the implementation and continuing environment be assessed for effectiveness?

## Scope

- ▶ Are the company's resources sufficient to adequately assess internal control over financial reporting this year?
- ▶ How will the audit of internal control over financial reporting be coordinated with management and the internal auditor?
- ▶ What factors will be considered to determine how much the tests of controls performed by others will be used?

- ▶ How do you understand and document the flow of business processes (i.e., flowcharts) to ensure that the appropriate identification of risks and controls (application, IT-dependent and manual) have been designed and implemented to address them?
- ▶ Does the company employ a continuous control monitoring technology (i.e., governance, risk and compliance), and if so, how would it be assessed for effectiveness?
- ▶ Does the company have an internal or external footprint in emerging technologies, such as the cloud or mobile computing, and if so, how would it be assessed for effectiveness?
- ▶ How many applications are in scope? What processes are supported by outsourced applications?
- ▶ How are we leveraging technology to identify, document and test controls?
- ▶ What changes to the IT environment are expected over the next 12 to 24 months? What is the expected impact on controls as a result of the planned changes?
- ▶ If applicable, is the company prepared to be compliant with the new COSO internal controls framework by December 15, 2014? (Companies who choose to stay on the old framework must publicly disclose they are doing so.)
- ▶ Did management exclude any recently acquired business or other consolidated entities from its assessment of internal control over financial reporting?
- ▶ Does management plan to improve its internal control assessment process in the future?
- ▶ What form of opinion does the independent auditor expect to issue for the audit of internal control over financial reporting?
- ▶ If applicable, is the independent auditor satisfied with management's proposed language in its report on internal control over financial reporting to disclose material weaknesses that exist as of year-end? Do management's disclosures appropriately describe the circumstances relating to the material weakness and management's plans to remediate?
- ▶ How will any identified significant deficiencies and material weaknesses affect the independent auditor's strategy regarding the audit of the financial statements?
- ▶ Did the independent auditor have any disagreements with management over the characterizations of control deficiencies?
- ▶ What are the independent auditor's observations about the effectiveness of the company's control environment, including the tone at the top?
- ▶ Did the independent auditor identify any control deficiencies that could increase the risk of misstatements due to fraud?
- ▶ Did the internal auditor's or independent auditor's audit procedures uncover any instances of employee fraud, questionable or illegal payments, or violations of laws or regulations?

## Reporting matters

- ▶ What significant deficiencies and material weaknesses in the company's internal control over financial reporting were identified?
- ▶ For material weaknesses identified, what are the underlying causes of the weaknesses? For example, are they systemic or confined to a particular area?
- ▶ How did management respond to identified significant deficiencies and material weaknesses?
- ▶ Did management implement new controls or strengthen existing procedures to correct material weaknesses or significant deficiencies before year-end? If so, did management consider whether the reason for the change and surrounding circumstances represented material information that should be disclosed?

# Internal auditor

- ▶ Does the internal audit department evaluate its charter regularly to confirm that it is still appropriate? Does the charter specify that the internal audit responsibilities are limited to roles that will not hinder objectivity?
- ▶ Are the department's size and structure adequate to meet its objectives? Does the department have sufficient resources to accomplish the responsibilities outlined in the charter?
- ▶ What role will internal audit play in management's assessment of internal control over financial reporting? Has this been defined in the internal audit department's charter?
- ▶ If internal audit is assisting management with its SOX Section 404 assessment, how will this affect the internal audit department's project plan and resources in other important areas?
- ▶ Does the department appear to be objective? What procedures are performed to determine objectivity?
- ▶ What is the functional reporting of the department?
- ▶ Does the internal audit director have direct access, and report regularly, to the audit committee? Does the audit committee oversee employment decisions relating to the internal audit director?
- ▶ Is the experience level of the internal auditors adequate?
- ▶ Is the technical knowledge of the department members sufficient for them to perform their duties appropriately? Does the department have an appropriate continuing education program?
- ▶ Does the department have members with sufficient information systems auditing experience to address the level of technology used by the company?
- ▶ Do internal audit procedures encompass operational as well as financial areas?
- ▶ What criteria does internal audit use to establish and prioritize the annual and long-range internal audit plan? What is the current-year plan? Has internal audit coordinated this plan with the independent auditor? Is the department's work concentrated in areas of high risk, judgment and sensitivity?
- ▶ How has the department reacted to changes in the company's business environment?
- ▶ How has internal audit considered the company's critical accounting policies in its plan?
- ▶ How has internal audit considered the company's most significant accounting estimates and judgments in its plan?
- ▶ What types of reports does the internal audit department issue and to whom?
- ▶ Does internal audit issue its reports on a timely basis? Do these reports include sufficient detail for effective action by management and the audit committee?
- ▶ Has the department made any significant recommendations to management about improving internal controls? Does management have an appropriate and timely response to significant recommendations and comments made by the internal auditors? What follow-up and monitoring procedures are performed by internal audit?
- ▶ Was the department's involvement in the annual audit effective? What could be done in the future to maximize its effectiveness and efficiency? To what extent is outsourcing used in the internal audit function, and what areas are outsourced?
- ▶ Does the function have a periodic peer review performed, and if so, what were the results of the latest review?
- ▶ How do the internal auditors view the quality of the company's control environment, including the tone at the top?
- ▶ How do the internal auditors view the effectiveness of the company's antifraud programs and controls?
- ▶ Are the internal auditors aware of any known or suspected instances of employee fraud, questionable or illegal payments, or violations of laws and regulations?
- ▶ How involved is internal audit in investigating matters raised by whistle-blowers?
- ▶ How have the internal auditors assessed the risk of material misstatement, including the risk of material misstatement due to fraud, and what procedures have they performed to respond to those risks?
- ▶ Does internal audit advise the audit committee on its assessment of risk and risk mitigation strategies?



# Independent auditor

## Questions about the firm

- ▶ Is your firm independent with respect to the company?
- ▶ What are your firm's independence policies and related processes for monitoring compliance with those policies?
- ▶ What are your firm's quality control policies? What are the results of the latest peer and internal quality reviews? Is the firm the subject of any significant litigation or disciplinary actions by the SEC, the PCAOB or others? Is the firm the subject of any inquiry or investigation by regulatory bodies or others?
- ▶ What is your firm's industry expertise, and does the firm have auditors who specialize in our industry?
- ▶ What are your firm's international capabilities? How will you coordinate communications and audit procedures among international and US offices?
- ▶ Is your audit methodology consistent globally?
- ▶ Who will be assigned to the audit, and what are their qualifications and industry expertise?
- ▶ How much will the engagement partner(s) participate in the audit? Does the lead audit partner have sufficient time?
- ▶ Does the partner in charge of this account have the leadership skills and experience to bring all appropriate firm resources to the company when needed?
- ▶ How extensive are the firm's national office and other technical resources? Will the company's audit team receive prompt and responsive consultations from the national office's technical partners?
- ▶ Does the firm have effective plans for audit partner rotation?
- ▶ What are the estimated fees, how are they determined and how will you handle differences between the actual and estimated fees?
- ▶ How will the firm use the work performed for the audit of internal control over financial reporting when determining the work needed for the audit of the financial statements?
- ▶ How does the firm use technology in its audit?
- ▶ How does the firm share knowledge internally?

- ▶ If the engagement team cannot resolve an accounting or auditing matter, what other means are available for resolving the issue?

## Audit approach

- ▶ What is your audit approach?
- ▶ How will the internal and external audit functions coordinate their audit procedures effectively?
- ▶ What do you consider to be our high-risk areas relating to the financial statements?
- ▶ What procedures do you plan in these high-risk areas? How has management assessed the risk of material misstatement?
- ▶ What are your procedures for reviewing compliance with the company's conflict-of-interest policy and code of conduct?
- ▶ What are your plans for reviewing officers' expense accounts and other executive perks?
- ▶ What procedures will you perform to address the risk of material misstatement due to fraud, including the risk of management overriding controls?

## Multilocation considerations

- ▶ How do you determine which company locations to visit for the audit of the financial statements, and what are their assigned scopes? Do you believe any of our business lines are riskier than others? Why?
- ▶ Are there locations or areas that you considered high risk in prior years but no longer consider high risk? If so, why has your evaluation changed? What other significant changes from last year have you made in your planned procedures?
- ▶ Do you have plans for members of the corporate headquarters audit team to visit key locations? If not, why?
- ▶ Are other auditors involved in our integrated audit? If so, do you participate in their scope-setting process? How do you determine whether their work is adequate?
- ▶ How do you determine which locations to visit for the audit of internal control over financial reporting, and how does that differ from the selection process for the audit of financial statements?

- ▶ What type of coverage (e.g., percent of total assets, revenue, pretax income) do you obtain from the locations that you select for testing, both in the audit of financial statements and in the audit of internal control over financial reporting?
- ▶ How are statutory audits integrated into the group audit?

### Costs and staffing

- ▶ What are your fees for this year's audit? What caused the change from the prior year? Was the change due to revised audit scope, rate increases or changes in the company's operations?
- ▶ What process does the engagement team have in place to confirm that all services are preapproved, including specific preapproval for internal control-related services?
- ▶ Are the audit fees adequate in light of the size and complexity of the company's business and the risks facing the company and its industry? Has management pressured you to reduce fees?
- ▶ What are the engagement team's qualifications? Have there been any significant changes to the team's composition?
- ▶ What is your plan for audit partner rotation, as required by SEC independence rules? What steps will you take to contribute to a smooth transition to the new partner?
- ▶ Has the team experienced significant turnover? If so, what actions are being taken?
- ▶ Are you using offshore talent or delivery center resources? If so, how much?

### Matters for consideration regarding audit results

Independent auditors are required to present the audit results to the audit committee. The questions below can help guide discussion of the year-end review with the independent auditors:

- ▶ What are the company's critical accounting policies? In other words, what are the policies that are most important to the portrayal of the company's financial condition and results, and that require management's most difficult, subjective or complex judgments, often because of the need to make estimates?
- ▶ Did management select any material alternative accounting treatments? If so, why did it select them, and do they differ from the accounting treatment preferred by you?

- ▶ What are the most significant accounting estimates and judgments? What process does management follow in making those estimates and judgments? Has management changed any significant assumptions underlying these estimates and judgments in the current year? Does management appear to have any bias in its approach to making significant estimates?
- ▶ Did you discuss any issues with the SEC or other regulators?
- ▶ Did you make any changes in your scope or in planned procedures because of changes in your risk assessments? If so, why did they occur?
- ▶ Could any lawsuits or other contingencies significantly affect the company's financial position? What did the attorneys report to you about the status of litigation or other contingencies? Are the disclosures in the financial statements relating to contingencies adequate?
- ▶ Does the company have any significant tax exposure items? What years are open to review by the tax authorities? Has the IRS requested access to your tax accrual working papers for the company? Has the company provided you access to all documentation supporting its tax positions, including third-party tax opinions? Is the company's accounting and related documentation for tax exposure items reasonable?
- ▶ Did you use specialists or consult with your firm's experts on any significant issues?
- ▶ Did you become aware of any known or suspected instances of employee fraud, questionable or illegal payments or violations of laws or regulations?
- ▶ Have you identified any deficiencies in management's anti-fraud programs and controls?
- ▶ Are you aware of any other risks and uncertainties that the audit committee should know about?

### Changes from prior year(s)

- ▶ What is your overall evaluation of the degree of comparability between the presentation of this year's financial statements and that of prior years' financial statements? What were the causes of any significant differences in the company's approach to financial statement presentation? What reclassifications, if any, were made to prior years' reported amounts?

- ▶ Did the company make any initial adoption or modification of an accounting principle where an acceptable alternative accounting treatment would yield significantly different results?
- ▶ Did the company make any changes in accounting policies that had a significant effect on the financial statements of the current year or are expected to have an effect on future years? Are any accounting policy changes pending? Was the company's application of existing accounting policies consistent with that of prior years?
- ▶ How do the company's accounting policies compare with those of other companies in the industry?
- ▶ Did the company make any significant changes to internal control over financial reporting during the year, such as changes to implement new systems or to correct material weaknesses or significant deficiencies?

### Findings and conclusions

- ▶ Do you expect to issue unqualified opinions on the financial statements and internal control over financial reporting? Did you consider issuing anything other than unqualified opinions? How were any concerns resolved?
- ▶ Did you note any significant unusual transactions? Are you satisfied with the accounting treatment?
- ▶ Did management impose any limitations on the scope of the audit? Were you allowed access to all employees, records and company locations?
- ▶ What were the audit findings in the high-risk areas? Do you have any specific recommendations or comments in these areas?
- ▶ Did you propose any financial statement adjustments (including changes to disclosures) that management elected not to record? If so, what was management's underlying reason for not recording the audit differences (e.g., they were immaterial to overall operations), and are you satisfied that the unrecorded differences do not materially affect the financial statements?
- ▶ How do you evaluate the significance of these matters when concluding on whether they were material to the financial

statements? Have you considered under what circumstances items not determined to be material in the current period could become material in a future period?

- ▶ What are your views on the overall quality of earnings reported in light of management's accounting policies and practices?
- ▶ What are your observations regarding the effectiveness of the company's control environment, including the tone at the top?
- ▶ Did management exclude any recently acquired business or other consolidated entity from the assessment of internal control over financial reporting?
- ▶ How do the quality and thoroughness of management's assessment process compare to that of other companies reporting on internal control?
- ▶ Were any significant deficiencies or material weaknesses in the company's internal control over financial reporting identified during the audit?
- ▶ What are the underlying causes of any identified material weakness? Are they systemic or confined to one area?
- ▶ How did management respond to identified significant deficiencies and material weaknesses?
- ▶ Did the audit or internal control identify a significant number of deficiencies? If so, how were these evaluated in the aggregate?
- ▶ Did management implement new controls or strengthen existing procedures to correct material weaknesses or significant deficiencies before year-end?
- ▶ Are you satisfied with management's proposed language in its report on internal control over financial reporting to disclose material weaknesses that exist as of year-end? Do management's disclosures appropriately describe the circumstances relating to the material weaknesses and management's plans to remediate them?
- ▶ Does financial management have adequate resources, such as experienced personnel and the necessary technology?





## Examples

- ▶ Audit committee charter
- ▶ Report of the audit committee
- ▶ Meeting planner
- ▶ Financial expert questionnaire
- ▶ Audit committee self-assessment tool
- ▶ Annual evaluation of the independent auditor

# Example audit committee charter

**Note:** This audit committee charter example considers the audit committee requirements adopted by the SEC in Exchange Act Rule 10A-3, according to Section 301 of the Sarbanes-Oxley Act of 2002 and the listing standards of the NYSE and NASDAQ.

The listing standards of the securities exchanges require that audit committees have a written charter. This example charter addresses the significant duties and responsibilities of the committee, and incorporates elements of the audit committee responsibilities and requirements included in the listing standards of the various exchanges. This example charter is for illustrative purposes only. We encourage companies to obtain the advice and input of their legal counsel when developing and reviewing the audit committee charter and to tailor the charter as necessary.

Detailed tasks that the audit committee performs may be addressed in another document, such as the audit committee meeting planner. In addition, overall policies for corporate governance may be described in the company's corporate governance guidelines.

## Organization

- ▶ This Charter governs the operations of the Audit Committee. The Board of Directors shall appoint an Audit Committee (the Committee) of at least three members, consisting entirely of independent directors of the Board, and shall designate one member as chairperson or delegate the authority to designate a chairperson to the Committee. For purposes hereof, members shall be considered independent as long as they satisfy all of the independence requirements for Board Members as set forth in the applicable stock exchange listing standards and Rule 10A-3 of the Exchange Act.
- ▶ Each member of the Committee shall be financially literate, or become financially literate within a reasonable period of time, and at least one member shall be an "audit committee financial expert," as defined by SEC rules.
- ▶ Members shall not serve on more than three public company audit committees simultaneously unless the Board of Directors determines that such simultaneous service would not impair the member's ability to serve effectively on the Committee.
- ▶ The Committee shall meet separately and periodically with management, the personnel responsible for the internal audit function and the independent auditor. The Committee shall report regularly to the Board of Directors about its activities.

## Purpose

The Committee will have the following purpose:

- ▶ The Committee will provide assistance to the Board of Directors in fulfilling its oversight responsibility to the shareholders, potential shareholders, the investment community and others relating to: (1) the integrity of the Company's financial statements, (2) the effectiveness of the Company's internal control over financial reporting, (3) the Company's compliance with legal and regulatory requirements, (4) the independent auditor's qualifications and independence, and (5) the performance of the Company's internal audit function and independent auditor.
- ▶ The Committee will prepare the audit committee report that SEC proxy rules require to be included in the Company's annual proxy statement. In fulfilling its purpose, the Committee is responsible for maintaining free and open communication between itself, independent auditor, the internal auditors and management of the Company, and for determining that all parties are aware of their responsibilities.



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## Duties and responsibilities

- ▶ The Committee has the responsibilities and powers set forth in this Charter. Management is responsible for the preparation, presentation and integrity of the Company's financial statements; for the appropriateness of the accounting principles and reporting policies that are used by the Company; and for establishing and maintaining internal control over financial reporting. The independent auditor is responsible for auditing the Company's financial statements and the effectiveness of internal control over financial reporting, and for reviewing the Company's unaudited interim financial statements.
- ▶ The Committee, in carrying out its responsibilities, believes its policies and procedures should remain flexible in order to best react to changing conditions and circumstances. The Committee will take appropriate actions to monitor the overall corporate "tone" for quality financial reporting, sound business risk practices and ethical behavior.
- ▶ The following shall be the principal duties and responsibilities of the Committee. These matters are set forth as a guide with the understanding that the Committee may supplement them as appropriate.

## Risk management and controls

- ▶ The Committee shall discuss the Company's policies on risk assessment and risk management, including the risk of fraud. The Committee also shall discuss the Company's major financial risk exposures and the steps management has taken to monitor and control such exposures.
- ▶ The Committee shall review with senior management the Company's overall antifraud programs and controls.
- ▶ The Committee shall discuss with the internal auditors and the independent auditor the overall scope and plans for their respective audits, including the adequacy of staffing and budget or compensation.

## Financial reporting and disclosure matters

- ▶ The Committee shall meet to review and discuss the quarterly financial statements, including Management's Discussion and Analysis of Financial Condition and Results of Operations, with management and the independent auditor prior to the filing of the Company's Quarterly Report on Form 10-Q. Also, the Committee shall discuss the results of the quarterly review and any other matters required to be communicated to the Committee by the independent auditor under the standards of the Public Company Accounting Oversight Board (PCAOB) (United States).
- ▶ The Committee shall meet to review and discuss the annual audited financial statements, including Management's Discussion and Analysis of Financial Condition and Results of Operations, with management and the independent auditor prior to the filing of the Company's Annual Report on Form 10-K (or the annual report to shareholders if distributed prior to the filing of Form 10-K). Also, the Committee shall discuss the results of the annual audit and any matters required to be communicated to the Committee by the independent auditor under professional standards.
- ▶ The Committee's review of the financial statements shall include: (1) major issues regarding accounting principles and financial statement presentations, including any significant changes in the Company's selection or application of accounting principles, and major issues as to the adequacy and effectiveness of the Company's internal control over financial reporting and any specific remedial actions adopted in light of significant deficiencies or material weaknesses; (2) discussions with management and the independent auditor regarding significant financial reporting issues and judgments made about the preparation of the financial statements and the reasonableness of those judgments, including analyses of the effects of alternative GAAP methods on the financial statements; (3) consideration of the effect of regulatory and accounting initiatives, as well as off-balance sheet structures, on the financial statements; (4) consideration of the judgment of both management and the independent auditor about the quality, not just the acceptability, of accounting principles; and (5) the completeness and clarity of the disclosures in the financial statements.



- ▶ The Committee shall review and discuss with the independent auditor, before the filing of the Company's Annual Report on Form 10-K (or the annual report to shareholders if distributed prior to the filing of Form 10-K), all critical accounting policies and practices of the Company; all material alternative treatments of financial information within US GAAP that have been discussed with management, including the ramifications of using such alternative treatments and disclosures, and the treatment preferred by the independent auditor; and other material written communications between the independent auditor and management.
- ▶ The Committee shall review and approve all related-party transactions required to be disclosed according to SEC Regulation S-K, Item 404, and discuss with management the business rationale for the transactions and whether appropriate disclosures have been made.
- ▶ The Committee shall review and discuss earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies.
- ▶ The Committee shall discuss, with management and the internal auditors, management's process for assessing the effectiveness of internal control over financial reporting under Section 404 of the Sarbanes-Oxley Act, including any material weaknesses or significant deficiencies identified.
- ▶ The Committee shall review management's report on its assessment of the effectiveness of internal control over financial reporting as of the end of each fiscal year and the independent auditor's report on the effectiveness of internal control over financial reporting.
- ▶ The Committee shall discuss with the independent auditor the characterization of deficiencies in internal control over financial reporting. The Committee shall also discuss, with management, management's remediation plan to address internal control deficiencies. The Committee shall determine that the disclosures describing any identified material weaknesses and management's remediation plans are clear and complete.
- ▶ The Committee shall discuss with management its process for performing its required quarterly certifications under Section 302 of the Sarbanes-Oxley Act, including the evaluation of the effectiveness of disclosure controls by the Chief Executive Officer and Chief Financial Officer.
- ▶ The Committee shall discuss with management, the internal auditors and the independent auditor (1) any changes in internal control over financial reporting that have materially affected or are reasonably likely to materially affect the Company's internal control over financial reporting that are required to be disclosed and (2) any other changes in internal control over financial reporting that were considered for disclosure in the Company's periodic filings with the SEC.

## Independent auditor oversight and responsibilities

- ▶ The Committee shall be directly responsible for the appointment, compensation, retention and oversight of the work of the independent auditor in preparing or issuing an audit report or performing other audit, review or attest services for the Company. The independent auditor must report directly to the Committee.
- ▶ At least annually, the Committee shall obtain and review a report by the independent auditor describing: (1) the firm's internal quality control procedures; (2) 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, with respect to one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; and (3) all relationships between the independent auditor and the company to assess the auditors' independence.
- ▶ After reviewing the foregoing report and the independent auditor's work throughout the year, the Committee shall evaluate the auditors' qualifications, performance and independence. This evaluation should include the review and evaluation of the lead audit partner and take into account the opinions of management and the Company's personnel responsible for the internal audit function.
- ▶ The Committee shall determine that the independent auditor has a process in place to address the rotation of the lead audit partner and other audit partners serving the account as required under the SEC independence rules.
- ▶ The Committee shall preapprove all audit and non-audit services provided by the independent auditor, including specific preapproval of internal control-related services based on PCAOB Rule 3525, and shall receive certain disclosure, documentation and discussion of non-prohibited tax services by the independent auditor based on PCAOB Rule 3524. The Committee shall not engage the independent auditor to perform non-audit services proscribed by law or regulation. The Committee may delegate preapproval authority to a member of the Audit Committee. The decisions of any Committee member to whom preapproval authority is delegated must be presented to the full Committee at its next scheduled meeting.
- ▶ The Committee shall regularly review with the independent auditor any audit problems or difficulties encountered during the course of the audit work, including any restrictions on the scope of the independent auditor's activities or access to requested information, and management's response. The Committee should review differences that were noted or proposed by the auditors but were passed (as immaterial or otherwise) and any management or internal control letter issued, or proposed to

be issued, by the audit firm to the Company that is in addition to its audit report on the effectiveness of internal control over financial reporting.

- ▶ The Committee shall set clear hiring policies for employees or former employees of the independent auditor that meet SEC regulations and applicable stock exchange listing standards.

## Internal audit oversight and responsibilities

- ▶ The Committee shall review and approve the Internal Audit Department's annual audit plan and all major changes to the plan.
- ▶ The Committee shall review and discuss with the internal auditors the scope, progress and results of executing the internal audit plan.
- ▶ The Committee shall receive reports on the status of significant findings and recommendations, and management's responses.
- ▶ The Committee shall review the Charter, reporting relationship, activities, staffing, organizational structure and credentials of the Internal Audit Department.
- ▶ The Committee shall review and concur on the appointment, replacement, reassignment or dismissal of the Internal Audit Director, who shall have direct access to the Committee.
- ▶ The Committee shall review the annual performance of the internal audit function.

## Compliance oversight and responsibilities

- ▶ The Committee shall review the Company's compliance and ethics programs, including legal and regulatory requirements, and review with management its periodic evaluation of the effectiveness of such programs. The Committee shall review the Company's code of conduct and programs that management has established to monitor compliance with such code. The Committee shall receive any corporate attorneys' reports of evidence of a material violation of securities laws or breaches of fiduciary duty by the Company.
- ▶ The Committee shall establish procedures for the receipt, retention and treatment of complaints received by the Company about accounting, internal accounting controls or auditing matters, and the confidential, anonymous submission by Company employees of concerns regarding questionable accounting or auditing matters.

- ▶ The Committee shall determine the appropriate funding needed by the Committee for payment of compensation to the independent auditor engaged for preparing or issuing audit reports, or performing other audit, review or attest services for the Company.
- ▶ The Committee shall have the authority to retain outside counsel, accountants, experts and other advisors that it deems appropriate to assist the Committee in performing its functions. The Committee shall be provided with appropriate funding, as determined by the Committee, for payment of compensation to such outside counsel, accountants, experts and other advisors.
- ▶ The Committee shall perform an evaluation of its performance at least annually to determine whether it is functioning effectively. The Committee also shall discuss with the independent auditor the accountants' observations related to the effectiveness of the Committee.
- ▶ The Committee shall review and reassess the Charter at least annually and obtain the approval of the Board of Directors.

## Investigative authority

- ▶ The Committee shall be empowered to investigate any matter brought to its attention with full access to all Company books, records and personnel, using special counsel or outside experts when necessary or appropriate.

# Example report of the audit committee

This example Audit Committee Report reflects the content required by SEC Regulation S-K Item 306. Also included (and highlighted in gray) are enhanced disclosures observed in practice. A number of companies currently disclose more information about their audit committees than is required under relevant rules. With this example, we seek to alert audit committees to current disclosure practices.

Potential enhanced disclosure

## Report of the audit committee

The Audit Committee oversees the Company's financial reporting process on behalf of the Board of Directors. The Company's management has the primary responsibility for the financial statements, for maintaining effective internal control over financial reporting, and for assessing the effectiveness of internal control over financial reporting. In fulfilling its oversight responsibilities, the Committee reviewed and discussed the audited **[consolidated]** financial statements **[and the related schedules]** in the Annual Report with Company management, including a discussion of the quality, not just the acceptability, of the accounting principles; the reasonableness of significant judgments; and the clarity of disclosures in the financial statements.

The Committee is governed by a charter. A copy of the charter is available on the Company's website at **[specify location]**. The charter was last amended effective **[specify date]**. The Committee held **[XX]** meetings during fiscal year 20**[XX]**. The Committee is comprised solely of independent directors as defined by the **[indicate the applicable national securities exchange or national securities association]** listing standards and Rule 10A-3 of the Securities Exchange Act of 1934.

The membership of the Audit Committee, together with appointment dates and attendance at meetings, is set forth below:

Members	Committee member since	Attendance at full meetings during 20XX
[Name]	[Date]	[# of meetings attended out of total held (e.g., 7/7)]
[Name]	[Date]	[# of meetings attended out of total held (e.g., 7/7)]
[Name]	[Date]	[# of meetings attended out of total held (e.g., 7/7)]

The meetings of the Committee are designed to facilitate and encourage communication among the Committee, the Company, the Company's internal audit function and the Company's independent auditor. The Committee discussed with the Company's internal auditors and independent auditor the overall scope and plans for their respective audits. The Committee meets with the internal auditors and the independent auditor, with and without management present, to discuss the results of their examinations; their evaluations of the Company's internal control **[, including internal control over financial reporting]**; and the overall quality of the Company's financial reporting.



The Audit Committee recognizes the importance of maintaining the independence of the Company's Independent Auditor, both in fact and appearance. Each year, the Committee evaluates the qualifications, performance and independence of the Company's Independent Auditor and determines whether to re-engage the current Independent Auditor. In doing so, the Audit Committee considers the quality and efficiency of the services provided by the auditors, the auditors' (global) capabilities and the auditors' technical expertise and knowledge of the Company's operations and industry. Based on this evaluation, the Audit Committee has retained **[specify firm]** as the Company's Independent Auditor for 20[XX]. **[The firm]** has been the Independent Auditor for the Company (or its predecessor) since [XXXX].

The members of the Audit Committee and the Board believe that, due to **[the firm's]** knowledge of the Company and of the industries in which the Company operates, it is in the best interests of the Company and its shareholders to continue retention of **[the firm]** to serve as the Company's Independent Auditor. Although the Audit Committee has the sole authority to appoint the Independent Auditors, the Audit Committee will continue to recommend that the Board ask the shareholders, at the Annual Meeting, to ratify the appointment of the Independent Auditors.

The Committee reviewed with the independent auditor, which is responsible for expressing an opinion on the conformity of those audited **[consolidated]** financial statements **[and related schedules]** with US generally accepted accounting principles, its judgments as to the quality, not just the acceptability, of the Company's accounting principles and such other matters as are required to be discussed with the Committee by the standards of the Public Company Accounting Oversight Board (United States) (PCAOB), including PCAOB Auditing Standard No. 16, *Communications With Audit Committees*, the rules of the Securities and Exchange Commission, and other applicable regulations. In addition, the Committee has discussed with the independent auditor the firm's independence from Company management and the Company, including the matters in the letter from the firm required by PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*, and considered the compatibility of non-audit services with the independent auditor's independence.

**[The following paragraph is included for integrated audits.]**

The Committee also reviewed and discussed together with management and the independent auditor the Company's audited **[consolidated]** financial statements for the year ended December 31, 20[XX], and the results of management's assessment of the effectiveness of the Company's internal control over financial reporting and the independent auditor's audit of internal control over financial reporting. **[The Committee discussed with management and the independent auditor material weaknesses and significant deficiencies identified during the course of the assessment and the audit and management's plan to remediate those control deficiencies.]**

In reliance on the reviews and discussions referred to above, the Committee recommended to the Board of Directors, and the Board has approved, that the audited **[consolidated]** financial statements **[and related schedules]** **[and management's assessment of the effectiveness of the Company's internal control over financial reporting]** be included **[and/or incorporated by reference]** in the Annual Report on Form 10-K for the year ended December 31, 20[XX], filed by the Company with the Securities and Exchange Commission.

**[include names here]**

Audit Committee Chair  
Audit Committee Member  
Audit Committee Member  
July 1, 20[XX]

# Example meeting planner

This audit committee meeting planner can be used to maintain regular, ongoing contact with internal auditors, independent auditor and management, including the coordination of activities related to overall expectations. This planner provides an example of the format that may be used to coordinate communications, and it may be modified for each audit committee to include applicable activities.

A = At least annually Q = Quarterly AN = As necessary

	Frequency			Planned timing			
	A	Q	AN	Q1	Q2	Q3	Q4
<b>Financial management</b>							
Hold executive session with management							
Obtain agreement on responsibilities and communication and performance expectations							
Meet to review and discuss Annual Report on Form 10-K [10-KSB] and proxy statement, including MD&A and how reported results compared to plan							
Discuss with management the materiality of any identified audit differences not corrected by management and consider whether uncorrected differences could be material in future periods; discuss the expectation that accounting errors should be recorded when identified							
Meet to review and discuss Quarterly Reports on Form 10-Q, including MD&A and how reported results compared to plan							
Discuss the quarterly financial statement close process and how quarterly financial information is summarized							
Discuss earnings press releases and other financial information and earnings guidance provided to analysts and rating agencies							
Review management's process for performing its certifications under Sarbanes-Oxley Act Section 302							
Review management's certifications of quarterly and annual reports							
Evaluate culture and environment (e.g., tone at the top)							
Review management's project plan to perform annual assessment of the effectiveness of internal control over financial reporting under Sarbanes-Oxley Act Section 404, including the sustainability of the process							
Review results of management's assessment and related report on internal control over financial reporting, including disclosures describing any identified material weaknesses and management's remediation plans							
Discuss the characterization of deficiencies in internal control over financial reporting							
Discuss management's remediation plan to address internal control deficiencies							



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Example meeting planner

	Frequency			Planned timing			
	A	Q	AN	Q1	Q2	Q3	Q4
Review new accounting and financial reporting requirements							
Discuss critical accounting policies and all material alternative accounting treatments that management has discussed with the independent auditor							
Discuss significant accounting estimates and judgments, and the rationale for those judgments							
Discuss proposed significant, complex or unusual transactions; the business rationale, approval and monitoring of such transactions; and their effect on the financial statements							
Discuss guidelines and policies to govern the process by which the Company addresses and manages its exposure to risk							
Discuss the process for identifying related-party transactions							
Discuss the business rationale for significant related-party transactions and whether they have been properly disclosed							
Discuss any issues that management and the independent auditor propose to address through the SEC's pre-clearance process and responses to SEC comment letters							
Review antifraud programs and controls at the Company							
Discuss the risk of management override of controls and any events, conditions or opportunities to perpetrate fraud							
Assess the risk of material misstatement due to fraud and how management has responded to those risks							
Assess the Company's business continuity plan							
Understand management's compensation structure							
Understand how management has reacted to changes in the Company's business environment							
Meet with management below the level of executive management							
Other matters (e.g., adequacy of staffing)							
<b>Independent auditor</b>							
Hold executive session with independent auditor							
Obtain agreement on responsibilities, deliverables, and communication and performance expectations							
Review the service team and evaluate their credentials and expertise, including the continuity of the team, their experience, and their competence to perform a high-quality audit							
Review and sign the audit engagement letter							
Discuss business and industry risk considerations							
Discuss key accounting and auditing developments							
Obtain and review their report on their internal quality control procedures and material issues from quality reviews, inquiries and inspections							
Discuss scope of annual audit and interim reviews and the related timing							
Determine that audit fees are appropriate to perform a quality audit							
Review results of timely quarterly reviews, including required communications <sup>1</sup>							
Review results of annual audit, including required communications							
Review a summary of unadjusted audit differences							
Discuss critical accounting policies and all material alternative accounting treatments that the independent auditor has discussed with management							
Discuss the characterization of deficiencies in internal control over financial reporting and any difference between management's assessment and that of the independent auditor							

<sup>1</sup> Note that the chair of the Audit Committee may represent the entire Audit Committee in order to facilitate conducting these reviews on a timely basis.



	Frequency			Planned timing			
	A	Q	AN	Q1	Q2	Q3	Q4
Review other material written communications that the independent auditor discussed with management							
Receive an audit scope update							
Understand areas of audit emphasis							
Consider plan for audit partner rotation to comply with SEC independence rules							
Preapprove all audit and non-audit services (specifically preapprove internal control-related services and receive certain disclosure, documentation and discussion of non-prohibited tax services from the independent auditor)							
Discuss independence of the independent auditor and understand its process for determining its continued independence in relation to the Company							
Discuss the quality of the Company's control environment, including the "tone at the top"							
Discuss the independent auditor's observations related to the effectiveness of the audit committee							
Discuss any significant deficiencies and material weaknesses in internal controls and the adequacy of management's plans for remediation							
Review disclosures related to material weaknesses, if any noted							
Discuss any significant recommendations for improvements in internal controls and the adequacy of management's response to the recommendations							
Discuss how management is complying with policies and procedures and any pressure it is under to accept less than high-quality financial reporting							
Discuss any identified or suspected fraud and illegal acts involving senior management and other employees							
Areas requiring special attention							
Results of special work or procedures							
Other matters (e.g., adequacy of financial staff)							
<b>Internal auditor</b>							
Hold executive session with director of internal auditing							
Obtain agreement on responsibilities and communication and performance expectations							
Review resources, expertise, the appropriateness of internal audit's staffing and the functional reporting of internal audit							
Review internal audit charter							
Review scope of internal audit plan for upcoming year							
Approve internal auditing costs (budget/actual)							
Discuss internal audit's coordination with independent auditor							
Discuss any identified or suspected fraud and illegal acts involving senior management and other employees							
Obtain and review results of compliance review of business conduct policy							
Obtain and review results of compliance review of director and executive officer perquisites and expenses							
Discuss the quality of the Company's control environment, including tone at the top							
Discuss any significant recommendations for improvements in internal controls and the adequacy of management's response to the recommendations							
Review summary of significant audit or review findings and status update relative to annual plan							
Review the results of the periodic "peer review," including the effectiveness and independence of the review and any action plan developed in response to the review							
Review the appointment, replacement, reassignment or dismissal of the Internal Audit Director							

Example meeting planner

	Frequency			Planned timing			
	A	Q	AN	Q1	Q2	Q3	Q4
Other members of management							
Discuss information systems matters (IT Director)							
Discuss tax matters (Tax Director)							
Review changes to the Company's compliance and ethics programs and receive reports from management related to monitoring of programs and responses to issues (Chief Compliance and Ethics Officer)							
Audit committee							
Report to the board of directors							
Appoint independent auditor							
Review audit committee charter							
Review annual proxy statement audit committee report							
Evaluate management's effectiveness							
Evaluate audit committee effectiveness (i.e., self-assessment) and the performance of its members							
Evaluate the financial expertise of the audit committee members							
Evaluate management's process for determining the continued independence of the independent auditor							
Evaluate business relationships and independence of members in relation to both the Company and the independent auditor							
Evaluate the processes and procedures in place for preapproval of audit and non-audit services of the independent auditor							
Approve audit committee meeting planner for the upcoming year and confirm mutual expectations with management and the auditors							
Evaluate performance of auditors							
Approve minutes of previous meeting							
Hold executive session of committee members							
Discuss fraud-related matters, including risk of fraud through management override of controls							
Hold orientation of new members and continuing education (e.g., current accounting and financial topics)							
Develop a succession plan for the committee chair and the audit committee financial expert							
Engage independent counsel and other advisors							
Review complaints received regarding accounting and auditing matters, including whistleblower information							
Understand the Company's Code of Conduct							
Receive updates about reports received from regulators and management's response							
Receive updates from the Company's attorneys on legal and regulatory matters							
Ask management and the Company's attorneys about any material violations of securities laws or breaches of fiduciary duty							
Review hiring policies for former employees of the independent auditor							

# Example financial expert questionnaire

Name of member: \_\_\_\_\_

## Attributes

### 1. An understanding of US GAAP and financial statements

The member acquired this attribute through:

Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor, or experience in one or more positions that involve performing similar functions

**Provide relevant details:**

Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or persons performing similar functions

**Provide relevant details:**

Experience overseeing or assessing the performance of companies or public accountants in preparing, auditing or evaluating financial statements

**Provide relevant details:**

Other relevant experience

**Provide relevant details:**

**Note:** This example of an audit committee financial expert questionnaire illustrates how an audit committee might evaluate a candidate for consideration as its financial expert. This questionnaire is helpful in determining whether a member can help the committee achieve financial literacy and can be identified as an audit committee financial expert as defined by the SEC. However, it is not meant to be the only means for the committee's evaluation of the financial expertise of members.

SEC rules (Item 401(h) of Regulation S-K) adopted in response to the disclosure requirements of Section 407 of the Sarbanes-Oxley Act of 2002 require a company to disclose annually whether it has at least one audit committee financial expert. If so, that company also must disclose the name of its audit committee financial expert and whether that person is independent, as defined. If it has more than one audit committee financial expert, the company may, but is not required to, disclose the names of any additional audit committee financial experts. If there is not an audit committee financial expert serving on the audit committee, the company is required to explain why not.



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## 2. An ability to assess the general application of US GAAP in the accounting for estimates, accruals and reserves

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The member acquired this attribute through:

Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor, or experience in one or more positions that involve performing similar functions

**Provide relevant details:**

Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or persons performing similar functions

**Provide relevant details:**

Experience overseeing or assessing the performance of companies or public accountants in preparing, auditing or evaluating financial statements

**Provide relevant details:**

Other relevant experience

**Provide relevant details:**



**3. Experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to issues reasonably expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities**

The member acquired this attribute through:

Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor, or experience in one or more positions that involve performing similar functions

**Provide relevant details:**

Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or persons performing similar functions

**Provide relevant details:**

Experience overseeing or assessing the performance of companies or public accountants in preparing, auditing or evaluating financial statements

**Provide relevant details:**

Other relevant experience

**Provide relevant details:**

#### 4. An understanding of internal control over financial reporting

---

The member acquired this attribute through:

Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor, or experience in one or more positions that involve performing similar functions

**Provide relevant details:**

Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or persons performing similar functions

**Provide relevant details:**

Experience overseeing or assessing the performance of companies or public accountants in preparing, auditing or evaluating financial statements

**Provide relevant details:**

Other relevant experience

**Provide relevant details:**

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## 5. An understanding of audit committee functions

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The member acquired this attribute through:

Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor, or experience in one or more positions that involve performing similar functions

**Provide relevant details:**

Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or persons performing similar functions

**Provide relevant details:**

Experience overseeing or assessing the performance of companies or public accountants in preparing, auditing or evaluating financial statements

**Provide relevant details:**

Other relevant experience

**Provide relevant details:**

## Conclusion

**Does the member have the required attributes to be an audit committee financial expert?**



# Example audit committee self-assessment tool

Leading practice attributes of effective audit committees

Item	Self-assessment						Action plan
	5	4	3	2	1	n/a	
<b>Audit committee composition, structure and activities</b>							
Consists of members that have diverse, complementary backgrounds							
Distributes, at least annually, a written description of the expectations of audit committee members to prospective members to communicate the required commitment							
Performs an annual review of director independence to determine whether the directors are independent within the meaning of the SEC regulations and the exchange listing standards							
Requires the committee chair to have leadership experience and a strong finance, accounting or business background							
Institutes a succession plan for the committee chair position and for the audit committee financial expert							
Has an environment in which members are comfortable challenging each other and the audit committee chair, as appropriate							
Evaluates members' performance on a regular basis and takes any necessary corrective actions.							
Spends adequate time individually, and as a committee, on committee responsibilities							

5 = Strongly agree    4 = Agree    3 = Neither agree nor disagree    2 = Disagree    1 = Strongly disagree    n/a = Not applicable

Item	Self-assessment						Action plan
	5	4	3	2	1	n/a	
Reviews and revises the audit committee charter annually, as appropriate, to adequately reflect the audit committee's responsibilities							
Develops a meeting planner to make sure that the committee meets its responsibilities, as outlined in its charter							
Engages internal and external resources as necessary to carry out its duties							
Asks management with responsibility for the respective areas (e.g., IT, tax, legal counsel, risk management, corporate compliance and ethics) to present topics at the committee meetings							
Prepares minutes for all meetings and circulates them in draft form to members before they are finalized							
Provides orientation training for new committee members							
Provides continuing education for members							
Continuing education offered by the company adequately addresses the needs of the committee							
Annually evaluates the financial expertise of audit committee members							
Implements an action plan for improvements identified during the audit committee's annual self-assessment process							
Overall, the audit committee performs effectively							
<b>Committee chair performs the following:</b>							
Meets with management and the auditors before audit committee meetings to agree on the agenda and the materials for an advance mailing to the members of the committee							
Evaluates the frequency and length of meetings to allow adequate time to discuss important matters							
Directs the meetings							
Prioritizes topics							
Determines that all important topics are addressed							

Item	Self-assessment						Action plan
	5	4	3	2	1	n/a	
<b>Continuing education includes current matters related to:</b>							
Accounting developments							
Auditing developments							
Financial reporting developments							
Business and industry issues							
Ethics							
Fraud							
<b>Understanding the business and its risks</b>							
Discusses guidelines and policies to govern the process that the company uses to address and manage its exposure to risk							
Management provides the audit committee with timely updates, such as a risk dashboard, on the specific risk factors identified as the primary responsibility of the committee							
Has regular exposure, as appropriate, to management below the level of executive management							
Determines whether the company has an appropriate business continuity plan that has been tested							
Determines that the company has an effective compliance and ethics program (e.g., based on the Federal Sentencing Guidelines Manual)							
Receives updates from management about reports or inquiries from regulators or other outside parties (e.g., SEC, IRS) and its responses to those reports							
Receives timely updates from the general counsel on legal and regulatory matters that may have a material effect on the financial statements							
Has an effective process to respond to any reports from the company's attorneys about alleged violations of securities laws or breaches of fiduciary duties							

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Self-assessment

Item	Self-assessment						Action plan
	5	4	3	2	1	n/a	
<b>Understands the following matters related to the company:</b>							
Business and industry							
Strategy							
Competitors							
Organizational structure							
Types of transactions							
<b>Understands significant types of risks faced by the company in the current environment</b>							
Strategic risks (e.g., communication and investor relations; governance; major initiatives; market dynamics; mergers, acquisitions and divestitures; planning and resource allocation; reputational risk)							
Operational risks (e.g., hazards, IT, people/human resources, physical assets, sales and marketing)							
Financial risks (e.g., accounting and reporting, capital structure, credit, liquidity, market, tax)							
Compliance risks (e.g., code of conduct, legal, regulatory)							
<b>Asks how the following groups have reacted to changes in the company's business environment:</b>							
Management							
Internal auditors							
Independent auditor							
<b>Understands how the company does the following related to its written codes of conduct:</b>							
Publicizes the codes							
Monitors the codes							
Enforces the codes							



Item	Self-assessment						Action plan
	5	4	3	2	1	n/a	
<b>Maintaining oversight of the financial reporting process</b>							
<b>Tone at the top and fraud risks</b>							
Considers whether the company has adequate processes and controls to prevent and detect fraud							
Considers the risk of management override of controls							
Understands management's compensation structure, such as incentive bonuses and stock plans, and considers whether the compensation structure might encourage inappropriate behavior to maximize compensation							
Understands management's process for approval of, identification of and accounting for related-party transactions							
Evaluates complaints and whistle-blower information, received either directly through a company hotline or from company officers, about auditing or accounting matters							
Considers situations that may indicate improper earnings management							
<b>Monitors the overall corporate tone for:</b>							
High-quality financial reporting							
Sound business practices							
Ethical behavior							
<b>Questions the following groups about the quality of the company's control environment:</b>							
Management							
Internal auditors							
Independent auditor							
<b>Considers the presence of events or conditions (i.e., fraud risk factors) that could indicate:</b>							
Incentives or pressures for management to perpetrate fraud							
Opportunities to carry out fraud							
Attitudes or rationalizations to justify a fraudulent action							

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Self-assessment

Item	Self-assessment						Action plan
	5	4	3	2	1	n/a	
<b>Discusses with the following groups whether they are aware of any instances of employee fraud, allegations of fraud or suspected fraud:</b>							
Management							
Internal auditors							
Independent auditor							
<b>Discusses with the following groups whether they are aware of any questionable or illegal payments or violations of laws or regulations:</b>							
Management							
Internal auditors							
Independent auditor							
<b>Financial statements, disclosures and other reported information</b>							
Understands the company's financial results and how reported results compare to plan							
Understands significant balance sheet changes or changes in trends or important financial statement relationships							
Is knowledgeable of the critical accounting policies of the company							
Is involved in the discussions on any issue that management and the independent auditor propose to address through the SEC's pre-clearance process							
Determines what the effect would be on the financial statements if any unrecorded audit differences were corrected in the current period and considers whether those differences could be material in future periods							
Sets an expectation with management that accounting errors should be recorded when identified							
<b>Understands the following related to material alternative accounting treatments:</b>							
The material alternative accounting treatments selected by management							
The reasons why the material alternative accounting treatments were selected							
The internal auditors' views on the material alternative accounting treatments selected							
The independent auditor's views on the material alternative accounting treatments selected							

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Self-assessment

Item	Self-assessment						Action plan
	5	4	3	2	1	n/a	
<b>Challenges the following groups to identify the areas where significant estimates and judgments were used and to explain fully how they each made their judgments in those areas:</b>							
Management							
Internal auditors							
Independent auditor							
<b>Understands the following related to proposed significant, complex or unusual transactions:</b>							
What the proposed transactions are							
The business rationale for such transactions							
The financial statement effects of the proposed transactions							
Whether such transactions have been properly disclosed							
<b>Assesses whether there is adequate oversight – including management controls over the approval, monitoring and accounting for transactions of areas of historical complexity – with respect to the financial statements, disclosures and other reported information, including:</b>							
Consolidations, including special-purpose entities							
Derivative financial instruments							
Compensation activities, including share-based payments							
Pension and other postretirement liabilities, including periodic expense							
Revenue recognition							
Acquisitions, including purchase price allocations							
Income taxes, including uncertain tax positions							
Segments							
Other material areas							
<b>Asks detailed questions of the following groups when reviewing the financial statements, focusing on the quality of earnings, the overall quality of financial reporting and the transparency of disclosures:</b>							
Management							
Internal auditors							
Independent auditor							

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Item	Self-assessment						Action plan
	5	4	3	2	1	n/a	
<b>Financial reporting process</b>							
Assesses the consistency of the disclosures presented in the financial statements with those in MD&A and other non-financial statement disclosures before the financial statements are filed							
Obtains a briefing from management on how it develops and summarizes quarterly financial information and how the quarterly financial close process differs from the annual financial close process							
Discusses with management the non-GAAP information included in financial statement filings prior to public release							
Evaluates the earnings press release information, as well as financial information and earnings guidance provided to analysts and rating agencies							
<b>Determines whether Management’s Discussion and Analysis (MD&amp;A) appropriately explains the company’s financial results and the expectations for future results (i.e., trends). Specifically, the audit committee challenges the MD&amp;A’s:</b>							
Adequacy							
Transparency							
<b>Discusses the interim review of financial information with the following groups prior to the earnings release:</b>							
Management							
Independent auditor							
<b>Discusses the annual review of financial information, including the Form 10-K, with the following groups prior to the earnings release:</b>							
Management							
Independent auditor							
<b>Internal control over financial reporting</b>							
Monitors how management is assessing the adequacy and effectiveness of internal control over financial reporting							
Discusses with management its process for performing its certifications under Section 302 of the Sarbanes-Oxley Act							
Reviews management certifications on quarterly and annual reports							

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Item	Self-assessment						Action plan
	5	4	3	2	1	n/a	
Monitors management's sustainable process for its annual assessment of internal control over financial reporting under Section 404 of the Sarbanes-Oxley Act							
Obtains status reports on at least a quarterly basis of management's assessment of the effectiveness of internal control over financial reporting and the independent auditor's audit of internal control over financial reporting							
Discusses with management and the independent auditor the characterization of deficiencies in internal control over financial reporting and any differences between management's assessment and the independent auditor's assessment							
Discusses with management its remediation plan to address internal control deficiencies							
Determines that disclosures describing any identified material weaknesses and management's remediation plans are clear and complete							
Discusses with the internal auditors their recommendations for improvements in internal control over financial reporting, if any							
Discusses with the internal auditors whether management has adequately addressed their recommendations for improvements in internal control over financial reporting, if any							
<b>Questions the following groups about how they assess the risk of material misstatement, what their assessments are and how they respond to identified risks:</b>							
Management							
Internal auditors							
Independent auditor							

Item	Self-assessment						Action plan
	5	4	3	2	1	n/a	
<b>Maintaining oversight of the audit function</b>							
Has effective processes to review the appointment, replacement, reassignment or dismissal of the Internal Audit Director, including the direct reporting of internal audit to the audit committee							
Has effective processes for the appointment, compensation, retention and oversight of the independent auditor, including the direct reporting of the accountants to the audit committee							
Evaluates whether the independent auditor's engagement team collectively possesses the experience and competence to perform a high-quality audit							
Discusses with the independent auditor its quality control procedures and the results of its latest peer and internal quality reviews, as well as the status of significant litigation or disciplinary actions by the SEC or others							
Engages in open, substantive, active and direct interaction with the independent auditor							
Understands management's process for determining the continued independence of the independent auditor							
Understands the independent auditor's process for determining its continued independence in relation to the company							
Evaluates periodically the processes and procedures for preapproving audit and non-audit services of the independent auditor, including disclosure, documentation and discussion of non-prohibited tax services by the independent auditor based on PCAOB rules							
Understands the independent auditor's plan for audit partner rotation to provide continuity of service and a smooth transition							
Reviews policies about the hiring of former employees of the independent auditor							

Item	Self-assessment						Action plan
	5	4	3	2	1	n/a	
<b>On an annual basis, reviews the following related to the internal audit function:</b>							
Internal audit's charter							
The functional reporting of internal audit							
The appropriateness of internal audit's staffing							
<b>Reviews the following related to the work of internal audit and the independent auditor:</b>							
Reviews the planned scope of the internal auditors and any changes to the planned scope							
Reviews the planned scope of the independent auditor and any changes to the planned scope							
Reviews the results of the work of internal audit							
Reviews the results of the work of the independent auditor							
Considers the appropriateness of the coordination of the activities of internal audit and the independent auditor							
<b>Audit committee communications</b>							
Provides meaningful and focused updates to the board of directors after each committee meeting							
Encourages open communication among management, the auditors and the audit committee							
If the audit committee has been delegated responsibility for the company's compliance and ethics program by the board of directors: informs the board of directors about the content and operation of the company's compliance and ethics program, and about the audit committee's oversight of the implementation and effectiveness of the compliance and ethics programs							
If the audit committee has not been delegated responsibility for reviewing the company's Compensation, Discussion & Analysis (CD&A) disclosures in Form 10-K, then the board's compensation committee or its equivalent informs the audit committee that the compensation committee has (1) reviewed and discussed the CD&A disclosure with management, and (2) based on this review and discussion, recommended to the board of directors or the audit committee that the CD&A be included in the company's annual report on Form 10-K, proxy or information statement							

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Item	Self-assessment						Action plan
	5	4	3	2	1	n/a	
Provides an opportunity for the independent auditor to be available to the full board of directors at least annually to review the results of the audit							
Meets in private session (committee only) at least annually to assess management's effectiveness							
Communicates the results of its assessment of management's effectiveness to senior management and the board							
Inquires of the auditors about pressure by management to accept less than high-quality financial reporting							
Discusses with the independent auditor its observations related to the effectiveness of the audit committee							
<b>Discusses the audit committee's communication and performance expectations with:</b>							
Management							
Internal auditors							
Independent auditor							
<b>Meets privately with the following on a periodic basis to ask challenging questions and to obtain open, honest feedback:</b>							
Management							
Internal auditors							
Independent auditor							

The self-assessment tool content is based on survey results, rules, regulations and recommendations from the following materials:

- ▶ Recent EY surveys, insights and experiences.
- ▶ "Viewpoints" articles from the Audit Committee Leadership Network (North America) – Tapestry Networks, Inc. and EY.
- ▶ Rule 10A-3 of the Securities Exchange Act of 1934.
- ▶ NYSE Listed Company Manual Section 303A.00, Corporate Governance Standards.
- ▶ NASD Manual Rule 4350(d).
- ▶ PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements*, PCAOB Release No. 2007-005, May 24, 2007.
- ▶ The Sarbanes-Oxley Act of 2002.
- ▶ National Association of Corporate Directors, *Report of the NACD Blue Ribbon Commission on Audit Committees: A Practical Guide*, published by the National Association of Corporate Directors and The Center for Board Leadership, sponsored by Heidrick & Struggles International, Inc., 2010.
- ▶ New York Stock Exchange and National Association of Securities Dealers, *Report and Recommendations of the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees*, 1999.
- ▶ National Commission of Fraudulent Financial Reporting (Treadway Commission), *Report of the National Commission on Fraudulent Financial Reporting*, 1987.

# Example annual evaluation of the independent auditor

## Quality of services and sufficiency of resources provided by the auditor

The audit committee's evaluation of the auditor begins with an examination of the quality of the services provided by the engagement team during the audit and throughout the financial reporting year.

Because audit quality largely depends on the individuals who conduct the audit, the audit committee should assess whether the primary members of the audit engagement team demonstrated the skills and experience necessary to address the company's areas of greatest financial reporting risk and determine if they had access to appropriate specialists or national office resources during the audit. The engagement team should have provided a sound risk assessment at the outset of the audit, including an assessment of fraud risk.

During the engagement, the auditor should have demonstrated a good understanding of the company's business, its industry and the effect of the current economic environment on the company. Moreover, the auditor should have identified and responded to any auditing and accounting issues that arose from changes in the company or its industry, or changes in applicable accounting and auditing requirements. Another consideration for the audit committee is the quality of the engagement teams that perform portions of the audit in various domestic locations or abroad by the firm's global network or other audit firms.

### Sample questions

- ▶ Did the lead engagement partner and audit team have the necessary knowledge and skills (company-specific, industry, accounting, auditing) to meet the company's audit requirements? Were the right resources dedicated to the audit? Did the auditor seek feedback on the quality of the services provided? How did the auditor respond to feedback? Was the lead engagement partner accessible to the audit committee and company management? Did he or she devote sufficient attention and leadership to the audit?
- ▶ Did the lead engagement partner discuss the audit plan and how it addressed company- and industry-specific areas of accounting and audit risk (including fraud risk) with the audit committee? Did the lead engagement partner identify the appropriate risks in planning the audit? Did the lead engagement partner discuss any risks of fraud in the financial statement that were factored into the audit plan?



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- ▶ If portions of the audit were performed by other teams in various domestic locations, or abroad by the firm's global network or other audit firms, did the lead engagement partner provide information about the technical skills, experience and professional objectivity of those auditors? Did the lead engagement partner explain how he or she exercises quality control over those auditors?
- ▶ During the audit, did the auditor meet the agreed-upon performance criteria, such as the engagement letter and audit scope? Did the auditor adjust the audit plan to respond to changing risks and circumstances? Did the audit committee understand the changes and agree that they were appropriate?
- ▶ Did the lead engagement partner advise the audit committee of the results of consultations with the firm's national office technical partners or other technical resources on accounting or auditing matters? Were such consultations executed in a timely and transparent manner?

A broader but important consideration is whether the audit firm has the relevant industry knowledge, as well as the geographical reach necessary to continue to serve the company, and whether the engagement team effectively uses those resources. Other questions involve the results of the audit firm's most recent inspection report by the PCAOB, including whether the company's audit had been inspected, and if so, whether the PCAOB made comments on the audit's quality or results. The audit committee also may want to know, in general, how the firm plans to respond to the PCAOB comments and to any internal findings regarding its quality control program.

### Sample questions

- ▶ If the company's audit was subject to inspection by the PCAOB or other regulators, did the auditor advise the audit committee of the selection of the audit, the findings and the effect, if any, on the audit results in a timely manner? Did the auditor communicate the results of the firm's inspection more generally, such as findings regarding companies in similar industries with similar accounting or audit issues that may be pertinent to the company? Did the auditor explain how the firm planned to respond to the inspection findings and to internal findings regarding its quality control program?
- ▶ Was the cost of the audit reasonable and sufficient for the company's size, complexity and risks? Were the reasons for any changes to cost (e.g., change in scope of work) communicated to the audit committee? Did the audit committee agree with the reasons?
- ▶ Does the audit firm have the necessary industry experience, specialized expertise in the company's critical accounting policies and geographical reach required to continue to serve the company?
- ▶ How did the audit team respond to turnover on the engagement team? Were individuals with the appropriate skills and knowledge assigned to complete the audit?

- ▶ Did the audit engagement team have sufficient access to specialized expertise during the audit? Were additional resources dedicated to the audit as necessary to complete work in a timely manner?

## Communication and interaction with the auditor

Frequent and open communication between the audit committee and the auditor is essential for the audit committee to obtain the information it needs to fulfill its responsibilities to oversee the company's financial reporting processes. The quality of communications also provides opportunities to assess the auditor's performance. While the auditor should communicate with the audit committee as significant issues arise, the auditor ordinarily should meet with the audit committee on a frequent enough basis to make sure the audit committee has a complete understanding of the stages of the audit cycle (e.g., planning, completion of final procedures and, if applicable, completion of interim procedures). Such communications should focus on the key accounting or auditing issues that, in the auditor's judgment, give rise to a greater risk of material misstatement of the financial statements, as well as any questions or concerns of the audit committee.

PCAOB standards, SEC rules and exchange listing requirements identify a number of matters the auditor must discuss with the audit committee. Audit committees should be familiar with those requirements and consider not only whether the auditor made all of the required communications but, importantly, the level of openness and quality of these communications, whether held with management present or in executive sessions.

### Sample questions

- ▶ Did the audit engagement partner maintain a professional and open dialogue with the audit committee and audit committee chair? Were discussions frank and complete? Was the audit engagement partner able to explain accounting and auditing issues in an understandable manner?
- ▶ Did the auditor adequately discuss the quality of the company's financial reporting, including the reasonableness of accounting estimates and judgments? Did the auditor discuss how the company's accounting policies compare with industry trends and leading practices?
- ▶ In executive sessions, did the auditor discuss sensitive issues candidly and professionally (e.g., his or her views on, including any concerns about, management's reporting processes; internal control over financial reporting, such as a whistle-blower policy; the quality of the company's financial management team)? Did the audit engagement partner promptly alert the audit committee if he or she did not receive sufficient cooperation?

- ▶ Did the auditor make sure that the audit committee was informed of current developments in accounting principles and auditing standards relevant to the company's financial statements and the potential effect on the audit?

## Auditor independence, objectivity and professional skepticism

The auditor must be independent of the issuer and, in the case of mutual funds, independent of the investment company complex. Audit committees should be familiar with the statutory and regulatory independence requirements for auditors, including requirements that the auditor advise the audit committee of any services or relationships that reasonably can be thought to bear on the firm's independence.

The auditor's technical competence alone is not sufficient to deliver a high-quality audit. The auditor also must exercise a high level of objectivity and professional skepticism. The audit committee's interactions with the auditor during the audit provide a number of opportunities to evaluate whether the auditor demonstrated integrity, objectivity and professional skepticism. For example, the use of estimates and judgments in the financial statements and related disclosures (e.g., fair value, impairment) continues to be an important component of financial reporting. The auditor must be able to evaluate the methods and assumptions used and challenge, where necessary, management's assumptions and application of accounting policies, including the completeness and transparency of the related disclosures.

An important part of evaluating the auditor's objectivity and professional skepticism is for the audit committee to gauge the frankness and informative nature of responses to open-ended questions put to the lead audit engagement partner (and members of the audit engagement team as appropriate). Examples of

appropriate topics include the financial reporting challenges posed by the company's business model, the quality of the financial management team, the robustness of the internal control environment, changes in accounting methods or key assumptions underlying critical estimates, and the range of accounting issues discussed with management during the audit (including alternative accounting treatments and the treatment preferred by the auditor). The auditor also should be able to clearly articulate the processes followed and summarize the evidence used to evaluate the significant estimates and judgments, and the auditor should be able to form an opinion on whether the financial statements, taken as a whole, were fairly presented in accordance with GAAP.

### Sample questions

- ▶ Did the audit firm report to the audit committee all matters that might reasonably be thought to bear on the firm's independence, including exceptions to its compliance with independence requirements? Did the audit firm discuss safeguards in place to detect independence issues?
- ▶ Were there any significant differences in views between management and the auditor? If so, did the auditor present a clear point of view on accounting issues where management's initial perspective differed? Was the process of reconciling views achieved in a timely and professional manner?
- ▶ If the auditor is relying on management and internal audit testing, did the audit committee agree with the extent of such reliance? Were there any significant differences in views between the internal auditors and the auditor? If so, were they resolved professionally?
- ▶ In obtaining preapproval from the audit committee for all non-audit services, did the lead engagement partner discuss safeguards in place to protect the independence, objectivity and professional skepticism of the auditor?
- ▶ Does the audit firm have a succession plan for all partners subject to rotation?

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