2011 year-end issues audit committees should consider

As audit committees find themselves in the middle of another year-end reporting season, they continue to face change, economic volatility and regulatory uncertainty.

This document is designed to help audit committee members navigate this challenging environment. We lay out 20 questions audit committee members should consider asking as they prepare for their upcoming discussions with management and the external auditors. We also provide additional insights and references to Ernst & Young publications.
## 20 Questions

### Financial reporting

1. How is the company affected by current economic conditions throughout the world, particularly in Europe, and has it transparently disclosed the effects?
2. Has the company considered the SEC staff’s suggestions related to registrants with significant foreign operations?
3. To what extent does the company use third-party pricing services for fair value information, and how does it corroborate the pricing information it receives?
4. Is the company presenting its non-GAAP financial measures in accordance with SEC requirements?
5. Are the entity’s disclosures of its operating results, liquidity and capital resources, and its critical accounting estimates sufficiently transparent?

### Regulatory developments

6. How does management assess the company’s compliance risk profile from a business perspective? What metrics does the company use to quantify or monitor compliance risk?
7. How is the company adapting to the new compliance environment? Does the company have adequate resources to deal with regulatory compliance globally?
8. Do the company’s regulatory compliance and monitoring programs align with its growth and expansion strategies, including compliance with the requirements of the Foreign Corrupt Practices Act, the UK Bribery Act and other anti-bribery laws around the world?
9. How effectively is management addressing requirements in the Dodd-Frank Act, including “say on pay” and executive compensation?

### Risk Management

10. How have the company’s key business, strategic and operational risks changed as a result of global events such as the European sovereign debt crisis, the earthquake in Japan and the Arab Spring uprisings?
11. Does the company have the capacity and skills to meet upcoming business challenges or are its resources stretched?
12. Does the company have a crisis response plan that has been sufficiently tested and updated?
13. How is the company addressing the transformational implications of emerging technologies such as cloud computing? Has the company performed a comprehensive IT risk assessment?
14. When was the last time the company performed a “bottom-up” risk assessment? What changes were made based on the most recent risk assessment?

### Tax

15. Does the audit committee understand the processes that management uses to identify, measure and oversee various categories of tax risk? How has recent domestic and global tax legislation affected the company?
16. Are the company’s tax-related processes and internal controls sufficient? Does the Tax function have clear and close input into major transactions and business plans? Does the company have the appropriate level of tax resources in place?
17. Have all potential additional tax liabilities been adequately provided for?

### Audit regulatory initiatives

18. How would the company be affected by the various PCAOB proposals to enhance audit quality and transparency by revising the auditor’s reporting model, requiring mandatory audit firm rotation or expanding the auditor’s communication with audit committees?
19. How would the EC legislative proposals, if enacted, affect the company’s business?
20. Has the company participated in the standard-setting process and, if so, what input has it provided?
Questions

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Background

The slow economic recovery in the US and the sovereign debt crisis in Europe made 2011 a challenging year. Add to this agenda the uncertainty around new and pending regulations in the financial markets and there are many financial reporting issues for audit committees to consider.

Further discussion

**Sovereign debt**

Given the recent uncertainty, the SEC staff expects registrants to make investors aware of any exposure they have to European sovereign debt. On 6 January 2012, the SEC’s Division of Corporation Finance issued guidance that calls for registrants to disclose, among other things, gross funded exposure separately by country, segregated by sovereign (i.e., government entities) and non-sovereign (e.g., financial institutions, other companies) debt and by financial instrument. Audit committee members should discuss with management whether the company has any exposure to European sovereign debt and whether it has made the appropriate disclosures.

**Foreign operations**

The SEC staff also has increased its attention on disclosures about liquidity, risk factors, and the results of operations for companies with foreign operations. The staff will pay particular attention to a company’s disclosures when a foreign operation has a disproportionate effect on the financial statements relative to the company’s size.

The SEC staff continues to observe that registrants that have significant foreign operations and report under US GAAP may not have appropriate knowledge of US accounting standards. An entity without staff with appropriate qualifications and expertise in US GAAP may need to disclose a material weakness in its internal control.

**Third-party pricing services**

The SEC staff and the PCAOB have heightened their focus on the use by registrants of third-party pricing services in determining fair value for securities that are not actively traded. The SEC staff has made a number of comments about management’s responsibility to have a sufficient understanding of the valuation models, assumptions and inputs used by third-party pricing sources to determine the fair value of securities. The PCAOB also has been emphasizing these measurements in its standard setting and inspections. Audit committee members need to understand the risk associated with using third-party pricing services, including whether management has the right skills to understand valuation methodologies.

**Non-GAAP financial measures**

SEC rules prohibit the use of non-GAAP financial measures if they are misleading and/or are given greater prominence than GAAP measures. The SEC staff has observed a recent uptick in the use of certain measures that might be considered misleading, such as performance measures that exclude normal cash operating expenses necessary to operate the business, and urged preparers to “knock it off.” Companies should clearly articulate how non-GAAP financial measures are used in their financial statements and how they are useful to investors.

**Judgments and estimates**

Subjectivity and judgments are inherent in fair value, impairment and other important estimate analyses. Audit committee members should understand management’s framework and processes for making these estimates and judgments. Audit committee members may also discuss these estimates with the company’s external auditor.

Reference library

- Financial reporting briefs – Fourth quarter 2011 (December 2011)
- Technical Line – More focus needed on fair value information from third-party pricing sources (November 2011)
Questions

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Background
Heightened regulatory activity continues to require the attention of boards including audit committees. From the audit committee’s perspective, an awareness and understanding of laws and regulations and their effect on the company is important. New regulatory mandates are resulting in an expansion of the audit committees’ oversight agenda that is time-consuming and complex.

Further discussion

Heightened compliance environment
Regulators and enforcement agencies around the world have more tools and are becoming more prescriptive about what they expect from companies’ compliance programs. The financial crisis has resulted in governments around the world continuing to crack down on financial fraud, including insider trading and mortgage fraud.

Compliance experts say regulators are asking for more information and are expecting quick answers. Audit committees need to consider what practical steps the company can take to demonstrate compliance with regulatory regimes; and consider how the company can do business in this changing regulatory environment.

Enhanced anti-bribery efforts
Foreign Corrupt Practices Act (FCPA) enforcement continues to intensify and is likely to get even stronger in 2012. In a single week in April 2011, the SEC and DOJ levied nearly $300 million in FCPA related fines against three companies, including the Johnson & Johnson action focusing on health care providers as “foreign officials.”

The UK Bribery Act went into effect in July 2011. The Act draws no distinction between the public and the private sector when it comes to bribery, and makes no exception for facilitation or “grease” payments. It pays close attention to the role of individuals both in committing and in failing to prevent bribery. A prison term of up to 10 years can apply.

In February 2011, the Chinese Government passed an anti-bribery law that criminalizes providing “property to a foreign official or an official of an international public organization for the purpose of improper commercial benefit.”

Dodd-Frank Act – more than a year later
While the full effect of Dodd-Frank is yet to come, several provisions have been implemented and have led to increased stakeholder engagement, focusing more actively on governance and compliance practices. Shareholders and regulators are increasing their demands with respect to board oversight of compliance, and disclosure about corporate strategy and risk management.

SEC’s whistleblower bounty program
The SEC issued final rules on 25 May 2011 to financially reward whistleblowers who provide original information leading to a successful SEC enforcement of securities law violations resulting in a recovery of at least $1 million. The rules provide an option for whistleblowers to first report possible wrongdoing directly to the company, and cooperation with a company’s internal compliance system is one factor that can influence the size of the bounty.

What’s next for “say on pay”?
Say on pay will continue to be an issue in the upcoming 2012 proxy season. Of particular interest to investors and shareholders will be any changes to executive compensation policies. Shareholders are expected to continue to monitor company efforts to communicate with investors on pay, both through direct engagement and summary disclosure in the proxy statement.
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Background

A leading emerging practice for audit committees is to challenge management’s assumptions when assessing risk and planning for the future. An audit committee’s fresh perspective can ensure that the full board looks at the big picture when assessing risk and making strategic decisions.

Further discussion

Oversight in changing times

Events such as the earthquake in Japan, the Arab Spring uprisings and the European sovereign debt crisis have shown how interdependent the world’s financial and consumer markets are. This global connectivity poses risks in areas such as supply chains, cyber-security and regulatory compliance, to name a few. Audit committees should review how management has been responding to these market events.

Does management have a “battle ready” crisis response plan that has been tested and updated? Does the company have the right talent, cultural understanding, and skills to develop credible relationships with stakeholders in new markets? A good understanding of the fundamental trends driving the changes in the global economy is important.

Cloud computing

Cloud computing is gaining serious traction due to the availability of an efficient delivery system. Cloud computing takes IT outsourcing to a new level as data is held on a third party’s computer and accessed via the internet.

While cloud services are simpler to use and less costly than many in-house alternatives, they add complexity and risk to the businesses of established companies entering the cloud computing market as users or providers.

In October 2011, the SEC staff issued guidance to help registrants evaluate the types of disclosure they may need to make about the risk of cyber attacks and breaches. The guidance states explicitly that a company should consider the risks associated with attacks and breaches when disclosing material matters in its registration statements or periodic reports. The level and type of disclosure depend on a registrant’s facts and circumstances, including the probability of a cyber incident occurring and the magnitude of any effect on the registrant.

Audit committees need to understand emerging IT trends and the potential risks they create for the business.

Evaluating internal controls

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) recently released for public comment a proposed update to the “Internal Control – Integrated Framework” that would codify the internal control concepts in the original 1992 framework into 17 principles and supporting attributes, intended to help companies improve performance with greater flexibility, clarity and confidence. COSO Chairman Dave Landsittel observed, “Effective internal control allows organizations to adapt to a changing business landscape, and obtain confidence that controls mitigate risks to acceptable levels. This is key for the long-term success of any organization.” Comments are due by 31 March 2012. The COSO plans to issue the final framework in the fall of 2012. Audit committees may want to understand whether management plans to evaluate the practical effects of the proposal on the company.
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Background
Searching for efficiencies in both effective tax rates and business operations, companies are driving dramatic change in their business models with restructuring, finance transformation, outsourcing and centralization.

Further discussion

Understanding tax planning strategies
Tax planning strategies that were effective a few years ago may no longer provide adequate support for companies today or in the future. Companies increasingly realize this and are starting to take a more global and strategic approach to managing tax risk. Disclosure and transparency requirements and expansion in emerging markets are creating new tax risks.

Tax legislative changes and developments
The pace, volume and complexity of global tax policy, tax legislation and tax administration change is a source of more risk and uncertainty than ever before. With the landscape continually changing, companies find that effective planning has become more of a challenge and that complying with the wide array of global tax and regulatory filing requirements is consuming more and more resources.

Reference library
- 2011-2012 Tax risk and controversy survey – A new era of global risk and uncertainty
- FATCA Knowledge center
- 2012 Ernst & Young Tax Guide

Foreign Account Tax Compliance Act (FATCA)
FATCA requires foreign entities and foreign financial institutions to disclose to the Internal Revenue Service (IRS) direct and indirect ownership of assets in foreign accounts by US individuals or risk penalties. Proposed regulations for FATCA will be released in early 2012.

Tax controversy
Tax authorities have become more assertive in examining cross-border activities. The volume of tax information exchange agreements has increased more than 1,000%, and joint and simultaneous tax audits are here to stay. Audits are more frequent and aggressive, and thus more costly to defend or litigate, and assessments and penalties can total billions of dollars. Companies face unprecedented scrutiny and reporting of tax affairs by advocacy groups and news media, potentially hurting brand reputation.

Discussing with management the potential ramifications of specific tax disputes, including the risk of serious penalties and reputational damage, as well as the status of tax audits can help audit committees understand the processes management uses to identify, measure and manage a company’s tax risks.

Processes and internal controls
In addition to reviewing the status of existing tax issues, many audit committees also review the processes through which tax strategies are developed and issues are resolved. In this role, the audit committee may focus on the operations of the Tax department and related functions.
Audit regulatory initiatives

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18. How would the company be affected by the various PCAOB proposals to enhance audit quality and transparency by revising the auditor’s reporting model, requiring mandatory audit firm rotation or expanding the auditor’s communication with audit committees?

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Further discussion

Auditor report to be revamped?
Most respondents to the PCAOB’s concept release on improving the auditor’s reporting model generally disagreed with proposals requiring the auditor to provide more subjective views of a company’s financial reporting (e.g., an external auditor’s discussion and analysis section). Investors, on the other hand, generally supported these aspects of the concept release. The PCAOB expects to expose a proposal for public comment in the first half of 2012. In May 2011, the IIAASB issued a Consultation Paper, Enhancing the Value of Auditor Reporting: Exploring Options for Change, to study the feasibility of enhancing the communicative value and relevance of the auditor’s report through proposed revisions to international standards on auditing.

Auditor communications with the audit committee
The re-proposed standard would require auditors to modify and expand their communications with audit committees beyond what is currently required. The comment period closes on 29 February 2012.

European Commission
On 30 November 2011, the European Commission (EC) issued a set of legislative proposals related to its Green Paper, Audit Policy: Lessons from the Crisis. The EC initiated the Green Paper consultation in October 2010 to reassess the role of the auditor, auditor independence and the structure of the audit market in Europe. The EC’s proposed legislation is wide-ranging and comprehensive and, despite the weight of stakeholder response, includes controversial proposals, such as mandatory audit firm rotation, enhanced tendering requirements, and restrictions on non-audit services and audit-only firms. Audit committee members should watch closely as the EU legislative process proceeds.

Summary
These initiatives could significantly change the audit profession, the audit market and the responsibility of an audit committee. Audit committee members should actively participate in the policy-making process and encourage the company’s management to do the same.

Reference library

- To the Point – PCAOB seeks comment on expanded audit committee communications (January 2012)
- Technical Line – Respondents to PCAOB overwhelmingly oppose mandatory audit firm rotation (January 2012)
- EY POV: European Commission legislative proposals on audit policy (December 2011)
- Technical Line – What to consider when responding to the PCAOB about auditor independence and audit firm rotation (September 2011)
- To the Point – PCAOB explores changes to the auditor’s report (June 2011)
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