Leading practices and trends

Facing more scrutiny from regulators and investors, audit committees are continuing to challenge their roles. To perform their oversight responsibilities, audit committee members need to understand what information they need, how to analyze it and what questions to ask to gain insights and make informed decisions.

The following are emerging as leading practices for audit committees:

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Risk oversight

Risks by their very nature are uncertain and affect all areas of a business. The audit committee’s role is to review and challenge, where appropriate, the company’s risk profile and ensure that risk management processes are in place, especially those affecting financial reporting and reputational risks.

- 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 appropriate focus is being paid to the company’s 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 in 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 committee of the board is responsible for each
- Meet directly with key executives responsible for risk management and focus on whether they understand they are empowered to 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 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), their relevance to the company and the associated risks
- Understand whether IT security processes are updated as appropriate and are in line with the strategy of the company
- Review whether processes to evaluate acquisitions include an assessment of controls at the acquired entity, such as tone at the top and controls around IT risks
Committee composition and dynamics

The composition of the committee is critical to its effectiveness. Members with requisite skills, knowledge, independence and judgment are important. Their level of commitment and availability is also critical to the audit committee’s ability to perform its responsibilities effectively. A range of diverse perspectives and thinking helps strengthen the quality of audit committee deliberations and delivers real value for companies and shareholders, especially for companies that operate globally.

- Focus on committee composition, 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. The right balance is crucial and will fluctuate with changing circumstances.
- Consider the ability to work collectively, to challenge decisions in a credible manner and to avoid “groupthink”.
- Align audit committee meeting materials and agendas with priority areas:
  - Put significant areas first in advance materials and on the agenda.
  - Next, include and discuss matters for review and comment.
  - Present compliance matters, standard reports and informational items at the end of advance materials packages and meetings (they may not need to be discussed at the meeting).
  - Follow meetings with private and executive sessions with auditors and the internal auditor.
- Help promote healthy skepticism among fellow committee and board members.
• Consider alternative viewpoints
• Evaluate whether the company’s crisis preparedness is adequate
• Consider periodically rotating audit committee members, staggering the terms of service to have the benefit of new skills and perspectives
• Engage independent advisers, as necessary
• Recognizing the significant workload of board service, and especially of audit committees, consider policies limiting directors’ other board service or audit committee participation
• Conduct an annual committee self-evaluation, considering what the committee could have done better and what the committee needs to do next year
Oversight of financial reporting

A primary responsibility of the audit committee is to oversee the integrity of the company’s accounting and reporting practices and financial statements. As financial reporting becomes more complex, the audit committee needs to make sure that the financial statements are understandable and transparent.

- Provide discipline to ensure that 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, earnings, cash flows and liquidity positions 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 how they affect the company’s resource needs
- Learn about the company’s operations and significant risks without focusing overly on process
- Assess the quality of the accounting principles and the appropriateness of significant accounting policies, considering alternative treatments of generally accepted accounting principles
Oversight of internal controls

Internal controls form an integral part of a company’s enterprise risk management. The COSO framework presents five intertwined areas: control environment, risk assessment, control activities, information and communication and monitoring. While the audit committee’s key focus is on financial reporting controls, audit committees are increasingly overseeing controls that ensure legal and regulatory compliance.

- Understand key controls and financial reporting risk areas as assessed by the independent auditor, the internal auditors and financial management, as well as mitigating controls and safeguards
- Understand oversight of corporate taxes, an area where high-risk and high-dollar decisions are made; over the past several years, income tax accounting has led to the largest 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 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
- Evaluate whether the company devotes the resources required for its internal controls processes to function effectively
Relationship with independent auditor

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

- Exercise ownership of the relationship with the external auditor
- Get to know the lead partners and meet periodically with specialists (e.g., tax, IT, actuarial, SEC)
- 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 external auditor
- Focus on independence, including a preapproval process
- Consider the findings from the financial statements audit and ensure that management responds to the findings
- 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
Interaction with management

Audit committees rely heavily on management and, therefore, need to have an open and effective relationship. Audit committees are constantly juggling the delicate balance of overseeing management and making management decisions. An open and trusting relationship with management is important to audit committee members, who speak frequently with key management.

- Focus on the tone at the top, culture, ethics and hotline monitoring
- Conduct annual evaluations assessing management’s competency and integrity
- Work with management to anticipate and identify emerging issues
- Understand plans to address new accounting and reporting requirements
- Provide input to management’s goal setting
- Discuss succession planning for the CFO and staff
- Conduct pipeline and staff reviews, including identifying high-potential personnel
- Evaluate whether the audit committee receives adequate information on a timely basis
- Ascertain whether the information the committee receives contains the appropriate level of detail, whether issues are explained clearly and whether discussion with internal and external auditors corroborates the information
Interaction with internal auditors

The internal audit function is a key resource for the audit committee. The Institute of Internal Auditors requires that the purpose, responsibilities and authority of the internal audit function should be formally set. Effective internal audit functions report to senior management and in many companies directly to the audit committee.

- Assess 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 Section 404 compliance
- Conduct annual evaluations assessing the effectiveness and competence of the internal audit department
- Understand internal audit staffing and succession planning, addressing adequacy of internal audit resources
- 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
Interaction with compensation committee, risk committee and executive compensation

The interplay between executive compensation policies and risk management has been a particular area of focus by regulators and investors. Compensation committees should be engaged as management develops the compliance framework and procedures. The audit and compensation committee also should coordinate with each other.

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 certain financial metrics are employed in the company’s compensation plans. It can also review the proxy statement, the compensation discussion and analysis and other disclosures.

- Periodically conduct meetings with the compensation committee about management incentives and related topics
- Consider, in conjunction with the compensation committee, the appropriateness of the incentive structure and whether it contributes to increased fraud risk
- Determine whether adequate and appropriate focus is being paid to the compensation of officers and directors, including the appropriate use of corporate assets such as planes and apartments
Executive sessions

Audit committees are increasingly holding private sessions, often with internal audit, the external auditor and management. Audit committee members may use this time to reflect on issues, evaluate what is working and what opportunities exist for improvement, and identify follow-up actions.

- Schedule regular sessions with and without internal audit, the external auditor and management
- Schedule regular sessions with various members of management, such as the CFO, controller, general counsel and others as appropriate
- Consider private audit committee sessions both before and after meetings with the internal auditor, the external auditor and management
- Provide clear objectives and expectations for each meeting
- Prepare specific topics and questions
- Understand the response and resolution for each issue raised

Audit committee: leading practices and trends
Self-assessment and evaluation

To be successful, an audit committee must understand its responsibilities and monitor its effectiveness, identifying improvement needs and opportunities. Regular performance evaluation enables the audit committee to ensure that it is meeting the expectations of its members, the full board and regulators.

• Perform a self-assessment in a thorough manner rather than treating it as a compliance exercise
• Consider evaluating the performance of individual committee members and assessing the effectiveness of the committee as a whole
• Consider using self-assessment results as a catalyst to re-engineer processes, procedures and agendas, which should influence where the audit committee is spending time
• Communicate with the board on activities and recommendations
• An effective performance assessment process helps the audit committee to:
  • Prioritize its agendas and meeting structure and focus on critical issues
  • Consider the committee’s composition in the context of the company’s current and future strategy and challenges
  • Consider the timing, level of detail and quality of information provided by management
  • Identify areas for continuing education
Orientation and education

New members should have an appropriate understanding of the company, its products and services, risk areas and its internal controls and financial reporting systems. Members should be provided with sufficient background information. Although they will also be members of the board of directors, the nature, amount of information and knowledge will vary greatly for audit committee members. Regular training ensures that audit committee members maintain their knowledge and skills.

- Address board education in the company’s corporate governance guidelines to be consistent with NYSE listing standards
- Provide orientation of new members involving both company executives and the independent auditor
- Consider offering continuing education in specialized or regulated industry matters, industry trends, reporting, operations and related topics
- Consider customized programs of continuing education that address topics relevant to the company’s needs and incorporate company-specific processes and objectives
- Offer one-on-one and committee-level education
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