Audit Committees Expanded Roles Re

Audit committee members have a part-time job with full-time responsibilities. This notion has become abundantly clear to audit committee members of U.S.-listed companies, as they bear the uncertain weight of regulation. "Uncertain weight" refers to the natural fear of the unknown anytime regulation is introduced, especially when that regulation is intended to re-direct or change the behavior of individuals.

How can you comply with the regulation's presumably right principles while managing the cost and effort of compliance? How do you know if you have complied with the "spirit" of a regulation? What will prevent someone from second-guessing your decisions and actions?

These types of questions weigh heavily on the minds of audit committee members, especially those subject to the requirements of the Sarbanes-Oxley Act of 2002. Looking beyond the fear of and the frustration with the unknown, there are valuable lessons for all audit committee members, regardless of the organization they serve — public or private, for-profit or not-for-profit, U.S.-listed or otherwise.

This author often speaks before groups about audit committee best practices — usually in the context of the Sarbanes-Oxley Act requirements. It is far more helpful, however, to look at the underlying principles that yielded the requirements — for it is there that the universal underpinnings of effective audit committee oversight can be found.

Sections 205 and 301 of the act highlight three key roles for audit committees. First, they are to oversee the accounting and financial reporting processes and the financial statement audits of the companies they serve. Second, they must appoint, compensate and oversee the external auditor. Third, they must establish procedures for the "receipt, retention and treatment of complaints" regarding accounting, internal control or auditing matters; and "the confidential, anonymous submission by employees" regarding questionable accounting or auditing issues.

All this may seem daunting on paper — and, the effort involved is indeed extensive — but the idea is relatively universal that such independent checks and balances should be in place. In essence, every audit committee's role is to stand objectively in the gap between management, the external auditors and the people who provide the capital to make it all happen — the investors, owners and/or donors. They must ensure that those capital providers receive complete, accurate and timely financial information that has been subjected to an appropriate level of scrutiny.

Along those lines, every audit committee should be focused on five key areas:

1. Presence of Appropriate Accounting Skills

The need has never been greater for organizations to hire or engage accounting skills commensurate with the complexity of their business; and that need increases daily. The flow of business information continues to grow in both quantity and speed.

Likewise, the complexity of accounting and financial reporting requirements continues to grow as business transactions become more creative. Every organization that uti-

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lizes external capital needs to exercise diligence in accounting for and reporting its financial information. That diligence begins with a commitment to placing the right personnel with the right skills in the right positions.

Management's job is to make sure it has people in place who have the proper accounting and financial reporting skills. The audit committee's job is to make sure that management is doing its job. Audit committees are partially equipped for this task through knowing the accounting complexities and challenges a company faces — by virtue of its industry, geography or business practices —

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then inquiring about the quality and sufficiency of related accounting skills.

How do you know if your audit committee is complying with the "spirit" of a regulation? Or, will someone "second-guess" your decisions? A national audit firm executive discusses these and other challenges faced by today's audit committees.

By R. Trent Gazzaway

For example, audit committees that serve companies in the software industry should know that revenue recognition in that industry is complex and requires significant judgment. A reasonable question the audit committee in the software industry should ask, therefore, is, "Does the organization have personnel with the skills, experience, training and authority to properly account for software revenue?

Internal audit can prove invaluable here in providing an objective assessment of the presence of necessary skill sets. Likewise, the external auditors' comments can be valuable.

The audit committee may find it helpful to create a list of complex or higher-risk financial reporting areas, and then match those areas with specific skill sets. Examples of such areas are revenue recognition; cost/expense capitalization; structured transactions, such as derivatives or other financial instruments that must be measured at fair value and those requiring significant judgment, such as reserves or asset retirement obligations.

Geographic issues might include International Financial Reporting Standards (IFRS) or transfer pricing and other tax-related requirements. While this is not an exhaustive list of possible risk areas, it can help see the factors that influence the assessment.

Once an audit committee knows the accounting and financial reporting challenges an organization faces, identifying whether appropriate accounting skills are present is generally not that difficult. It does require judgment, but in most cases, the presence or lack of appropriate skills is fairly evident.

2. Internal Control Oversight

Regardless of whether or not an organization is subject to the requirements of Sarbanes-Oxley, good financial reporting requires good control.

Management should have a reasonable basis for knowing that its financial reporting processes work effectively, and that basis should be more than a general belief that, "We have good people and we haven't had a problem in the past."

Such a belief, by at least some in management and by the audit com-

mittee, has been at the forefront of virtually every restatement resulting from error or fraud.

Well-run organizations establish internal controls to help manage and mitigate risk, but without proper oversight and monitoring, even the best internal control systems will deteriorate over time. Effective internal control monitoring should be incorporated into the DNA of the organization. This does not mean that every risk and every control should be monitored equally. It does mean that management should:

- Know the financial reporting risks the organization faces and have a reasonable method of prioritizing them and identifying changes over time.
- Know what controls are in place to help manage and mitigate the critical risks.
- Implement monitoring procedures that provide persuasive and timely information as to the effective operation of those important controls.

The audit committee's job is to make sure management is doing those three things routinely and effectively. It can accomplish this task by asking the right questions and probing the answers for reasonableness.

How, for example, does management identify and prioritize financial reporting risks? How often does it update this analysis? Do those procedures seem reasonable in the context of the organization's operations and structure? What controls are in place to mitigate the risks that seem most critical to the financial reporting process, and how does management know those controls are working correctly?

These are not merely Sarbanes-Oxley questions. They are good management questions. Good production managers can tell you the potential errors in their manufacturing processes, how they monitor to make sure those errors don't occur and what they would do if they occurred. Why would we expect anything less from the financial reporting processes?

3. Auditor Oversight

Of all of the aspects of the auditor oversight role, two are of greatest importance.

First (similar to number 1 above), the audit committee should be confident that the auditors have the appropriate skill sets and commitment to properly address the areas of greatest financial reporting risk. If numbers 1 and 2 above are properly attained, then this goal should be relatively easy to attain as well.

Every audit committee's role is to stand objectively **in the gap between management**, the external auditors and the people **who provide the capital to make it all happen** — the investors, owners and/or donors.

The committee will already know the most important financial reporting areas, leaving the remaining step to talk to the auditors about their skill sets, training and experience in those areas. This aspect might also involve some discussions with management and internal audit to gather additional information and viewpoints.

The second facet of auditor oversight is more sensitive and slightly more judgmental. The audit committee should be confident that the auditors have the fortitude to be frank and honest regarding their assessment of organizational processes, skills and attitudes. This is especially important if members of senior management have aggressive personalities and/or management styles.

The only way to assess the auditors' capabilities in this area is to ask challenging, open-ended questions about the organization, its policies, the management team, etc., and then gauge the frankness of their responses. This assessment is most effective when conducted in a private session between the audit committee and the auditors.

Other important aspects of auditor oversight include reviewing the audit plan, evaluating the cost-effectiveness of the audit and reviewing the resulting reports. But none of these oversight roles can be performed effectively if the auditors do not have the right people and resilience.

4. Sufficient Audit Committee Resources

An audit committee needs appropriate resources — which typically come from the skills and time commitment of individual audit committee members, internal audit, other hired experts and the external auditors. Audit committee members need to devote appropriate time, both in and outside of audit committee meetings, to gain an understanding of the organization's operations and financial reporting risks; they must also be given access to the right information in a timely manner.

Management should provide financial information and other material far enough in advance of meetings for audit committee members to review them and develop questions. It may also be necessary for audit committee members to spend some time observing operations, particularly in the areas of higher financial reporting risk. This is another area where a qualified internal audit department can prove to be a valuable resource.

When staffed appropriately, supervised properly and given appropriate autonomy, internal audit can quickly become the eyes, ears, arms and legs of the audit committee. The relationship between internal audit and the audit committee becomes increasingly important as organizations grow in size and complexity.

Other hired experts can fill the gaps where specialized skills are needed on a limited or interim basis, such as in accounting for an acquisi-

tion or periodically assessing asset or liability valuations.

Finally, the audit committee can and should follow up on areas of concern identified by the external auditors. External auditors' independence requirements prohibit them from becoming a part of the organization's internal control system. Thus, while the auditors' work might influence the audit committee to probe more deeply in areas where the external auditors identify potential issues, the committee should not ignore other areas simply because the auditors did not find problems.

5. Understand the Economics Behind Every Transaction

If a person cannot explain the economic reality behind a transaction (i.e., how the cash flows work and how the transaction is expected to benefit the organization), the odds are high that he or she does not know how to account for that transaction.

Complex derivatives, sale-leaseback agreements involving assets unrelated to the organization's core business, contracts or arrangements in locations where the organization does not normally do business — these are just a few examples of transactions that are naturally high-risk from a financial reporting perspective and possibly high-risk from an economic perspective.

Management is responsible for knowing the fundamental purpose and expected outcome of every significant transaction. The audit committee must be confident that management and those responsible for recording transactions understand the fiscal aspects.

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TakeAways

>> Audit committees bear the "uncertain weight" of regulations, meaning the natural fear of the unknown anytime regulation is introduced, especially regulation intended to change behavior.

>> Every audit committee should focus on five areas: presence of appropriate accounting skills, internal control oversight, auditor oversight, sufficient audit committee resources and understanding the economics behind every transaction.

>> The committee may find it helpful to create a list of complex or higher-risk financial reporting areas, and then match those areas with specific skill sets. These might include revenue recognition, cost/expense capitalization and structured transactions.