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TONE at the TOP

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EXCLUSIVELY FOR SENIOR MANAGEMENT, BOARDS OF DIRECTORS, AND AUDIT COMMITTEES

The Audit Committee's "Top 10"

Today's audit committee members spend increasingly more time fulfilling their role than did their counterparts of yesteryear. Largely, this is due to scandals resulting from corporate malfeasance and subsequent regulations and legislation passed in an effort to rebuild stakeholder trust. The U.S. Sarbanes-Oxley Act of 2002 (SOX) moved select powers from the C-level suite to the audit committee. This transfer of power has required audit committee members to be more knowledgeable and more highly skilled, and to devote substantially more time and effort to their role. For many organizations in both the U.S. and around the world, time spent on audit committee work has doubled.

This edition of *Tone at the Top* discusses and provides commentary on Frederick Lipman's 10 best practices for audit committees. Taken from a more extensive list of 30 best practices delineated in Lipman's book, *Corporate Governance Best Practices,* these 10 practices originally were featured in *Financial Executive* magazine.

1. Establish effective internal auditing.

The primary responsibility of the internal audit activity is to assist the board in performing its fiduciary duty to monitor management — in other words, to act as the eyes and ears of the audit committee. Hence, establishing an effective internal audit activity with appropriate reporting relationships to the audit committee and the CEO is probably the most important action the audit committee can perform.

The audit committee is responsible for hiring and compensating the chief audit executive (CAE), and should consider structuring the compensation to avoid excessive reliance on compensation driven by accounting results. In other words, the CAE should not receive significant incentives based on profitability.

The audit committee must maintain control of the internal audit operations that deal with the auditing of financial reporting. The Institute of Internal Auditors (IIA) believes the internal audit activity should maintain a balanced scope of work that examines risk from operational, financial, compliance, reputation, and strategic perspectives.

Sometimes an organization does not have all of the skills needed on staff and might outsource or "co-source" part of the internal audit activity. If a company enters into an internal audit outsourcing or co-sourcing arrangement, The IIA believes the in-house CAE should manage the process and projects.

2. Ensure organizational ethics.

A key element of creating an ethical, law-abiding culture within an organization without discouraging entrepreneurial risk-taking is the tone at the top of the organization. When those at the top "walk the walk," they set an example for openness and integrity. This sensitizes employees to the need to communicate significant legal risks to management and to the audit committee or nominating/corporate governance committee of the board of directors. The U.S. Department

Questions to Ponder

- How important are ethics within the operational structure of your organization?
- What is the tone of your organization's ethical culture?
- What do executive management and the audit committee do to help foster an ethical environment throughout your organization?
- Is an ethics policy and/or program in place?
- How are ethics and expectations of behavior communicated throughout your organization?
- Is an anonymous hotline or other reporting mechanism in place for reporting violations without fear of reprisal?

of Justice guidelines require the board to create an ethical culture to avoid criminal indictment of the organization, and sometimes, irreparable damage to its reputation. Financial incentives should be provided to the CEO to create such a culture.

3. Communicate.

Audit committees cannot operate properly without gathering information from diverse sources, both within and outside the company. On a yearly basis, the audit committee should interview the external auditors, the CEO, and the CFO. In addition, at least once a year, the committee should consider interviewing:

- The comptroller and assistant comptroller to determine whether they are uncomfortable with any accounting policies or procedures currently in place.
- The head of sales to learn about any side deals with customers, channel stuffing, or so-called "roundtrip" sales, etc.
- The tax manager to find out whether the company is pursuing any aggressive tax strategies.
- Inside and outside counsel.
- The disclosure committee chairman.
- The corporate governance officer.
- The head of information technology.
- The head of corporate development.
- The head of purchasing.

Something prosecutors have known for many years is that subordinates do not talk freely when their bosses are present. Each of the persons named above should be interviewed separately and not in the presence of superiors within the company.

4. Monitor use of inside information.

The temptation to inflate earnings is greatest prior to the intended sale of stock by management. Audit committees should conduct more intensive and extensive audits on the eve of insider sale of significant amounts of stock. The audit committee should adopt a policy requiring written notice of insider sales several months before the actual date of such sales to arrange the necessary audits.

5. Notice red flags.

Other warning events should alert an audit committee to conduct more intensive and extensive audits. For example:

- Short sellers take a significant position in the company stock. Could they know something the audit committee doesn't?
- The company never fails to meet an earnings projection. Is this realistic?
- The chief executive officer or chief financial officer is under personal financial pressure, which may stem from a lavish lifestyle, divorce, gambling habits, or other issues. Do large bonuses or salary increases depend on the company's financial results?

6. Control conflicts of interest.

Should the audit committee ever elect to approve a conflict of interest, ongoing independent monitoring is essential. This may include more extensive audits by the external auditor, possibly supplemented by internal audit oversight. The external and internal auditors should report results directly to the audit committee. This is an important safeguard or internal control.

COSO's Perspective on Communication

- Pertinent information must be identified, captured, and communicated in a form and timeframe that enable people to carry out their responsibilities.
- Information systems produce reports containing operational, financial, and compliance-related information that make it possible to run and control the business. These reports should deal not only with internally generated data, but also information about external events, activities, and conditions necessary for informed business decision-making and external reporting.
- Effective communication also must occur in a broader sense, flowing down, across, and up the organization. The staff must receive a clear message from top management that control responsibilities must be taken seriously.
- Personnel must understand their own role in the internal control system, as well as how individual activities relate to the work of others. They must have a means of communicating significant information upstream.
- There also needs to be effective communication with external parties such as customers, suppliers, regulators, and shareholders.

COSO: The Committee of Sponsoring Organizations of the Treadway Commission

COSO's Components of Internal Control

- Control Environment
- Risk Assessment
- Control Activities
- Information and Communication
- Monitoring

7. Ask questions.

The audit committee should ask the external auditors several key questions:

- If you were solely responsible for the company's financial statements, would you prepare them differently?
- If you were an investor, would the information the company has provided give you a proper understanding of the financial performance during the reporting period?
- Do you know of any operational facts that caused the company's sales or profit to vary significantly from one quarter to the next?

8. Ensure external auditor independence.

If the external auditor is not independent, both the company and the external auditor are in violation of the Securities Exchange Act of 1934. When adopted by the audit committee, the following policies will help ensure independence of the external auditor:

- The engagement letter should contain a representation that the external auditor is — and will remain — independent throughout the audit engagement.
- At least once a year, the audit committee will conduct a robust discussion with the external auditor about independence, including relationships with management that might impair objectivity.
- After conducting non-audit services, the external auditor must represent to the audit committee that those services do not impair independence.
- The hiring of a former employee of the company's external audit firm could jeopardize the external auditor's independence. The HR department will be required to notify the audit committee prior to hiring such an individual.

9. Seek tax services elsewhere.

According to Securities Exchange Commission rules, tax-planning services do not impair the independence of external auditors. However, the external auditor is prohibited by auditor independence rules from providing an expert opinion or other expert services for an audit client. The external auditor also is prohibited from acting as an audit client's legal representative in litigation or in a regulatory or administrative proceeding or investigation.

The effect of this prohibition is that the external auditor is unable to provide assistance in advocating the company's tax position before the Internal Revenue Service (IRS), since the IRS inquiry might be viewed as a "regulatory or administrative proceeding or investigation." Using the organization's external auditor in this way would handicap the company in the defense of its tax planning, and might not be in the best interest of the company.

10. Consider impacts.

SOX rules require the external auditor to disclose preferred accounting treatments. The audit committee must determine on a case-by-case basis whether these treatments should be adopted by the company, and what the overall effect would be.

If the audit committee decides not to adopt the external auditor's preferred treatment, it carefully should document the reasons for the rejection, with the assistance of counsel, in order to protect the audit committee members from personal liability.

A SHORTCUT TO SUCCESS

It's safe to suggest that most people would not expect serving on an audit committee to be fun and games, but this list clearly is a tall order. How can audit committee members focus on all of these areas, while fulfilling their other roles? Can they possibly be effective with so much on their plates? And if they feel they must omit something, how do they go about choosing what to drop from the list?

Actually, there is a "shortcut," but it does not include cutting corners. Being diligent about the first item on the list can go a long way toward ensuring the other nine are covered.

An effective, professional internal audit activity can provide meaningful insights and assurance on all areas of risk, internal control, and governance. After all, when utilized to its best potential, that's what internal auditing is supposed to do.

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Mission

To provide executive management, boards of directors, and audit committees with concise, leading-edge information on such issues as ethics, internal control, governance, and the changing role of internal auditing; and guidance relative to their roles in, and responsibilities for, the internal audit activity.

Your comments about *Tone at the Top* are welcomed.

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Established in 1941, The IIA is an international professional association with global headquarters in Altamonte Springs, Fla. The IIA has more than 150,000 members in internal auditing, risk management, governance, internal control, IT auditing, education, and security.

The IIA is the global voice, recognized authority, chief advocate, principal educator, and acknowledged leader in certification, research, and technological guidance for the internal audit profession worldwide. The IIA presents conferences and seminars, certifies qualified audit professionals, provides benchmarking, and through The IIA Research Foundation, conducts research projects and produces educational products.

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