



External audit and the audit committee

Strengthening audit oversight

21 May 2010

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Where are audit committees today?

- ▶ More than ever, audit committees are focusing on the effects of the economy on a company's operations, financial results and internal controls
- ▶ Leading companies' audit committees are concentrating on:
 - Scrutinizing financing on an ongoing basis
 - Broadening analysis of near-term risks and key relationships
 - Analyzing year-end reporting issues
 - Revisiting financial plans and budgets
 - Re-evaluating financial communications
 - Ensuring controls remain robust
 - Considering implications for enterprise risk management and anti-fraud programs
- ▶ Questions to consider:
 - Has your audit committee changed its focus lately?
 - Are you concentrating on issues that matter?
 - How has the audit committee's relationship with the independent auditor changed in response to changes in the environment?

Where are audit committees going?

- ▶ What changes may occur with risk oversight regulators and how might companies and audit committees prepare to deal with them?
 - The pendulum is swinging towards more regulation
 - Possibilities for a risk regulator role and legislated "enterprise risk management process" requirements
 - The Fed is likely to take on a risk oversight role
 - Instances of fraud are on the upswing
 - ▶ Regulatory gaps that have been identified will provide a boost to re-regulation efforts.
 - ▶ Health care fraud and abuse prevention and detection are a high priority for regulators
 - Audit scrutiny is, perhaps, at an all-time high

The audit committee's view

- ▶ Observations regarding companies' enterprise risk assessment processes and implications to the audit committee
 - The top concerns for audit committees
 - ▶ The most devastating risks come from unanticipated sources
 - How does management identify and monitor those risks?
 - Is the independent auditor aligned with management and the audit committee with a common view of enterprise risk?
 - ▶ Access to sufficient risk expertise within the audit committee and its supporting structure
 - How does the audit committee periodically assess effectiveness?
- ▶ Risk management and internal control questions for audit committees to consider
 - How actively do we manage the relationship with our independent auditor?
 - Have new or increased risks affected financial reporting and audit scope?
 - Does management have an appropriate basis and scope to assess internal controls over financial reporting and anti-fraud measures?
 - Where does the internal control assessment fit into the audit committee governance?
 - What external factors influence internal control?

The audit committee's view

- ▶ Companies need independent audit committees with deep financial expertise
 - More engagement and deeper knowledge
- ▶ The audit committee should see the company through the eyes of others
 - Deep, healthy skepticism
- ▶ Strong and objective audit governance must be a priority
 - Independence and deep qualifications
- ▶ The audit committee should be attentive to all aspects of the external audit process
- ▶ Fraud risks should be explicitly considered and discussed – don't assume someone else has it covered
- ▶ The audit committee charter should be an active, guiding set of clear principles
 - Oversee independent auditors – meaningful discussion of audit scope and required communications
 - Oversee internal audit and compliance functions – audit scope, plans of correction and remediation monitoring
 - Review financial reporting policies and principles and internal control
 - Review conflicts of interest
 - Monitor whistleblower program

Risk mitigation and control

- ▶ The risk mitigation umbrella – consider internal control at the entity level
 - Independent (external) audit
 - ▶ Financial statements
 - ▶ Policies and procedures relevant to significant financial statement accounts and processes
 - ▶ Specific scope (e.g., grant audits, OMB Circular A-133 audits)
 - Internal audit
 - ▶ Internal polices and procedures; efficient practices
 - ▶ Fraud
 - ▶ Special investigations and requests of audit committee and management
 - Compliance
 - ▶ Compliance with laws and regulations
 - ▶ Areas of regulatory scrutiny
 - Other audit functions
 - ▶ Example – internal controls group
- ▶ Generally, role is to monitor and detect – prevention and detection
 - Not to design, implement or maintain internal controls

Pop quiz – how well do you know...?

- ▶ Does your Board define the risks that fall within the oversight of the audit committee?
- ▶ What are the company's risk priorities?
- ▶ What are the most important areas of risk?
- ▶ How are risk resources – external audit, internal audit and compliance functions – allocated relative to the management of important areas of risk?
- ▶ How often does the organization consider the sufficiency of resources dedicated to risk management?
- ▶ What are the major business initiatives being considered and what are the associated significant risks?
- ▶ How does the risk management program consider new business strategies, initiatives and transactions and those that related to external factors (e.g., new regulatory interpretations, focus areas)?
- ▶ Does management provide frequent enough updates to the Board and audit committee responsible for oversight of risk management?
- ▶ Are the risk updates prioritized, clear and concise (e.g., does management uses a risk dashboard)?
- ▶ How does the company assure that its risk management programs do not cause the company to become risk averse?

Risk identification – ask yourself...and ask the external auditors their views....

- ▶ Do you know the top ten risks most prevalent to your organization?
- ▶ Are you focused on the three areas you believe are most vulnerable?
- ▶ What pressures are senior managers and employees exposed to?
- ▶ Is the internal controls environment aligned to address the risks that matter most?
- ▶ How much do you rely on chance to discover a problem?
- ▶ Are you comfortable with your organization's ability to recover from a catastrophic event?

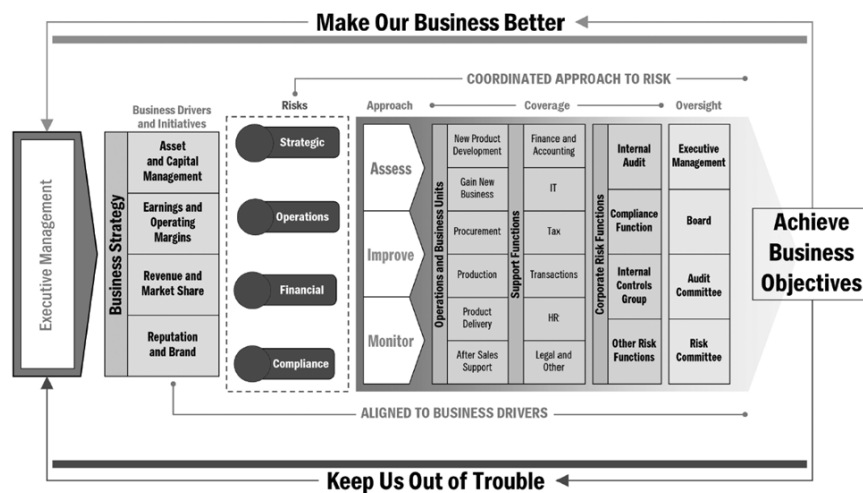
How well do you interact with your external auditors? Tips to be successful...

- ▶ Hold executive sessions
- ▶ Agree on responsibilities, scope and deliverables; set communication protocols
- ▶ Review and evaluate the service team
- ▶ Discuss business and industry risks and key accounting and auditing considerations
- ▶ Review internal quality control, quality reviews, inspections, etc.
- ▶ Determine that audit fees are sufficient
- ▶ Review audit results, areas of audit emphasis and required communications
- ▶ Discuss formal and informal observations; ask about areas requiring special attention
- ▶ Include the external auditors in assessment of anti-fraud controls
 - Assess fraud risks – incentives/pressures, opportunities, attitudes

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A view of risk...from the top



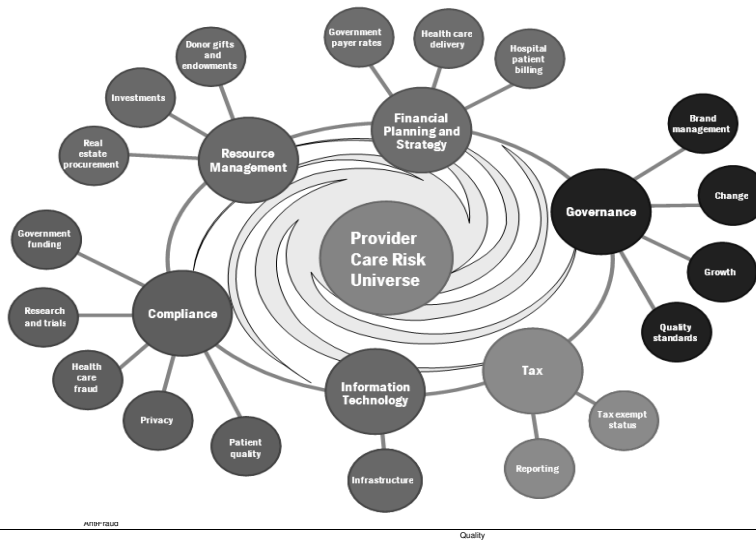
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Start...by defining the process

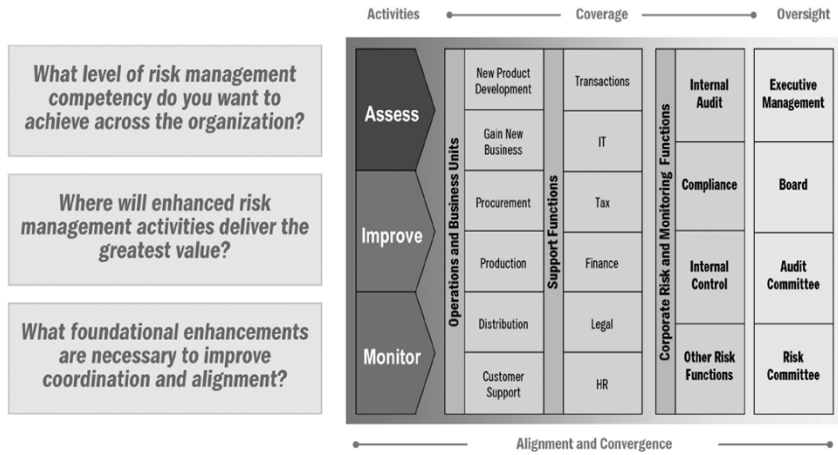
- ▶ Periodic, routine evaluation
- ▶ Starts at the top
 - Oversight from Board to executive management
 - Requires senior-most view of what's important to the organization
 - ▶ Risk tolerance
 - ▶ Financial, reputational, quality, strategy
- ▶ Covers significant functional areas
 - Dispersed accountability and central reporting
 - Requires strong knowledge of organization functions across the enterprise
- ▶ Considers inherent risk without effects of controls and audit functions
 - Includes periodic (annual) discussion of fraud and anti-fraud controls
 - Focuses on future strategies (and historic results)
 - Plan for tomorrow's business strategies and tomorrow's risks
 - Know and discuss your risk universe; acknowledge changes

What does risk look like for your organization?

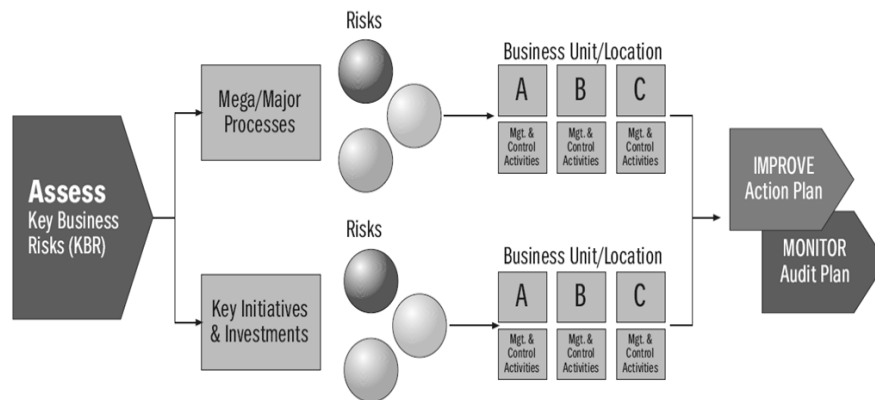


Then...develop a perspective

Coordinating the Lines of Defense



Finally...understand and oversee the process



What the audit committee should do on the outside...

- ▶ Actively monitor the external audit function
- ▶ Ensure adequate processes and controls
 - Ask leading questions
- ▶ Ensure frequent, robust communication from other Board committees
 - Integrate other committee work into audit committee agendas
- ▶ Assess the integrity of the culture and tone at the top – create an environment of openness and accountability
 - Understand the vulnerabilities with respect to fraud
 - Use employee surveys to gauge corporate culture
 - Oversee codes of conduct and associated ethics programs – insist on complete, unfiltered reporting of whistleblower complaints
 - Demand separation of the fraudster
- ▶ Gain exposure to the wider management team – get to know finance people at levels below the CFO
- ▶ Provide support for all levels of risk mitigation

What the audit committee should do on the outside...consider external audit results

- ▶ Ask the external auditors about:
 - Audit scope
 - Accounting and reporting matters
 - Internal control over financial reporting
 - Exposure areas
 - Changes from prior years
 - Findings and conclusions
 - Costs and staffing
- ▶ Consider a private session with the external auditors to discuss:
 - Cooperation by management
 - Management's reporting philosophy
 - Management's response to identified deficiencies
 - Reasons for audit differences
 - Management's integrity; compliance and anti-fraud programs
 - Quality of earnings
 - Your areas of greatest concern and theirs

What the audit committee should do on the inside...assess

- ▶ Assess effectiveness – leading examples to collaborate with the external auditor
 - Does the committee have the right people and skills for the tasks at hand?
 - ▶ Work with other committees to plan membership and succession
 - ▶ Evaluate financial literacy and expertise of committee members
 - Does the committee provide for its own education?
 - ▶ Evaluate the committee's knowledge of relevant financial reporting and accounting policies
 - ▶ Provide formal education on complex and current issues
 - How is the committee's agenda set?
 - ▶ Use risk to address business issues and prioritize the agenda
 - ▶ Manage information flow and overload
 - Does the committee use assessment processes to improve its performance?
 - ▶ Formal evaluation with the board and audit committee
 - ▶ 360-degree review
 - ▶ Has the committee undergone an independent third-party review?

What the audit committee should do on the inside...improve

- ▶ Improve effectiveness – leading examples
 - Set agendas in advance and prioritize later
 - Use consent agendas
 - Make sure pre-reading is concise and directly relevant to the planned discussion
 - Cultivate the right mix of presentation and discussion
 - Improve discussion by focusing on assumptions
 - Focus attention on the most important items
 - Delegate important responsibilities to other audit committee members
 - Ensure the full committee brainstorms new agenda items at least annually
 - Uncover pan-organizational themes
 - Don't just add agenda items; remove less relevant ones
 - Request interim management reports

What the audit committee should do on the inside...monitor

- ▶ Monitor effectiveness – leading examples
 - Examples of changes resulting from audit committee assessments
 - ▶ Length and timing of meetings
 - ▶ Composition and structure of the committee
 - ▶ Identification of new agenda items
 - ▶ Changes in individual director behaviors
 - ▶ Improvement in the quality and timeliness of pre-meeting reading material
 - ▶ Improved and increased communication between management, the external auditor and the committee

What to do next...

- ▶ **Understand** key financial processes, controls and financial reporting
- ▶ **Know** the business and ask questions
- ▶ **Consider** effects of information technology
- ▶ **Question** significant assumptions
- ▶ **Evaluate** sufficiency of audit plan
- ▶ **Follow up** prior recommendations and remediation
- ▶ **Judge** depth and expertise of risk mitigation team
- ▶ **Meet** in private session
- ▶ **Allow** time for discussion – questions matter
- ▶ **Ask** for feedback
- ▶ **Assess** results

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