

Audit Committee Responsibilities for Internal Controls

Lord & Benoit, LLC, a SOX 404(a) Consulting Firm focused on small to mid-sized public companies.

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Today's Speaker



Bob Benoit is President and Director of SOX for Lord & Benoit. Served on the most recent COSO Monitoring Project Task Force. Served on AICPA Peer Review Acceptance Board for ten years. Author of most the Lord & Benoit Reports, which have been referenced by the SEC, PCAOB, Wall Street Journal, all Big 4 firms and over 150 trade journals worldwide. First evaluator to use the 2006 COSO Guidance for Smaller Public Companies. Invented Virtual SOX. Significant contributor to SEC Interpretive Guidance, SEC/PCAOB Roundtables and SEC Subcommittee on Internal Controls

Today's Topics

- Regulatory Update
- Financial Expert Requirement
- Interaction with Internal Audit/Evaluators
- Risks, Hotline Complaints
- Audit Committee's Role in SOX Section 302
- Audit Committee's Role in SOX Section 404(a)
- Audit Committee Charter and Calendar of Events

Regulatory Update



Financial Expert Requirement



Section 407 of the Sarbanes-Oxley Act requires disclosure of at least one audit committee member:

- ▣ Education and experience as a public accountant
- ▣ Auditor
- ▣ Principal financial officer, Controller or principal accounting officer of an issuer,
- ▣ Position involving the performance of similar functions

Financial Expert Requirement

ALL of the following skill sets:

1. Understands GAAP and financial statements
2. Experienced in the preparing or auditing financial statements.
3. Understands the application of principles in estimates, accruals and reserves.
4. Experienced in internal accounting controls
5. Understands the function of the audit committee.

Financial Expert Requirement

In other words...

Financial Reporting



Financial Expert Requirement

In other words...

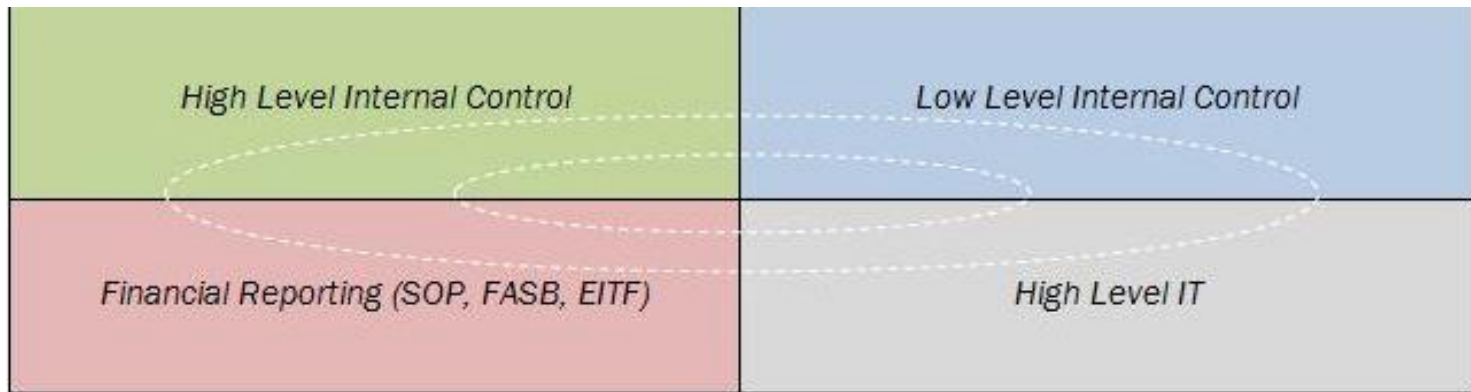
Financial Reporting



Interaction with Evaluators



SOX 404(a) management assessment, which is documenting and testing internal controls over financial reporting typically requires four skill sets:



Interaction with Evaluators

Evaluators must be competent and objective for the assessment to be valid (cannot test their own work and must have experience if checking someone else's work)



The COSO Internal Control Integrated Framework
Figure 4

”Both evaluators and their information sources (i.e., the people responsible for providing information to evaluators) need to be appropriately competent and objective”

Interaction with Evaluators

A direct reporting relationship should be made between the audit committee and the internal auditors.

True story...



Interaction with Evaluators

It is not adequate to assume evaluators are monitoring critical controls and risks...

...the **audit committee** has **ultimate** oversight responsibility



Interaction with Evaluators

Evaluate the performance of the evaluator



Interaction with Evaluators

Regular (and sometimes private) sessions should be held between the audit committee and the evaluators

COSO 2006... Does the audit committee meet privately with the internal auditors to discuss relevant matters?

Interaction with Evaluators

Questions for Audit Committees to Consider

- ▣ Are the internal auditors responsive to the needs of today's rapidly changing environment?
- ▣ Are the internal auditors cognizant of new laws, regulations, and best practices?
- ▣ Are internal audit personnel experts in their field?

Interaction with Evaluators

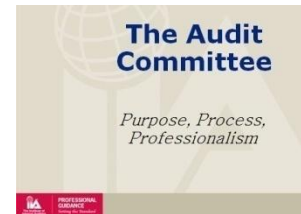
Questions for Audit Committees to Consider

- ▣ Is the internal audit department viewed as objective and competent by the independent auditor?
- ▣ Does internal auditor and audit committee have a clear understanding of the strengths and weaknesses of the organization's internal control and risk management systems?

Interaction with Evaluators

Resources:

- The Institute of Internal Auditors: The Audit Committee: Purpose, Process, Professionalism
- AICPA's Audit Committee Toolkit includes "Guidelines for Hiring the Chief Audit Executive,"



Risk Assessment



Audit committee should review and periodically evaluate the status of the enterprise-wide risk assessment and the audit plans.

- SEC requires the audit committee be responsible for **financial risks** and for overseeing the process for identifying and addressing those risks.
- However, they also indicate that ALL of the board has the ultimate responsibility for risk oversight.

Risk Assessment

NYSE commentary clarifies that

- It is the responsibility of senior management to assess and manage the company's risks,
- But that the audit committee should focus on areas of major financial risk exposure and discuss the guidelines and policies for addressing these areas.

Risk Assessment

Risk assessment is a critical component of the SOX 404(a) process, both enterprise risk assessment and fraud risk assessment. The audit committee has ultimate responsibility for ensuring management has documented and TESTED internal controls over financial reporting in its disclosures to the public in the Form 10K.

Risk Assessment

Audit committee should consider the effectiveness of the company's enterprise risk management, some questions to consider are:

- What are the processes for assessing and managing major financial risk exposures?
- What are the key risks?
- How capable is the company of recovering from major financial risk exposures?

Risk Assessment

Audit committee should determine that the company has programs and policies in place to prevent and identify fraud.

- Does the company's assessment of fraud risks consider incentives and pressures, attitudes, and rationalizations, as well as opportunity to commit fraud?
- Does the company's assessment consider risk factors that influence the likelihood of someone committing a fraud on financial reporting?

Risk Assessment

Audit Committee should work with management to oversee the establishment of appropriate controls and antifraud programs and to take the necessary steps when fraud is detected.

- Do responsibility and accountability for fraud policies and procedures reside with the management of the business or function in which the risk resides?

Risk Assessment

Audit committee should gain an understanding of the company's ethics, compliance and complaint hotline

- Has top management developed a clearly articulated statement of ethical values that is understood at all levels of the organization?
- Are processes in place to monitor adherence to principles of sound integrity and ethical values?

Risk Assessment

Audit committee responsibility for ethics, compliance and complaint hotline (continued):

- Are deviations from sound integrity and ethical values identified in a timely manner and addressed and remedied at appropriate levels within the company?
- Are separate lines of communication in place and do they serve as a “failsafe” mechanism in case normal channels are inoperative or ineffective?

Risk Assessment

Audit committee should have a good understanding of fraud risks (asset misappropriation and fraudulent reporting)

- ▣ Asset misappropriation (expenditures, wires, cash application, payroll, investments, inventory, IT access controls)
- ▣ Fraudulent financial reporting (management override of controls, journal entries, excel docs)

Risk Assessment

Audit committee can oversee the prevention and detection of fraud by monitoring management's assessment of internal control over financial reporting (ICFR)



Risk Assessment

Final thoughts on enterprise and fraud risk assessments:

- The audit committee should also have an awareness of the U.S. Foreign Corrupt Practices Act (FCPA) and
- Guidance(s) from the Committee of Sponsoring Organizations of the Treadway Commission.
- SEC Interpretive Guidance Regarding Internal Controls over Financial Reporting.

Whistleblower Hotline



Audit Committee must ensure procedures are established for whistleblower hotline complaints. This would include:

- Understanding the procedures around the receipt, retention, and treatment of complaints received by the issuer regarding accounting and internal control matters.
- Understanding the process for handling the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.

Whistleblower Hotline

Audit Committee should consider the following guidelines for administering whistleblower complaints:

- Segregation of duties are effective, so that more than one person in the company is notified of a complaint simultaneously (or at least one person in management and the audit committee chair).
- Complaints are summarized including an analysis of situation, recommendations and resolutions.

Whistleblower Hotline

Audit Committee responsibility for whistleblower complaints (continued):

- Recommendations regarding the reduction of future similar complaints.
- Reports should be sent to audit committee regularly even if no complaints were filed.
- High risk complaints should be forwarded to the board and audit committee immediately, particularly those relating to senior management.

Disclosure Controls



Audit committee should ensure that management complies with Section 302 disclosure controls, by reviewing the need to disclosure any significant deficiencies found during the quarter being reported upon.

- ▣ This would require the Audit Committee to keep in sync with the management assessment (SOX 404(a)) on a quarterly basis



Disclosure Controls

Audit committee must ensure that the chief executive officer and the chief financial officer certify in each annual and quarterly report:

- ▣ that they are responsible for establishing and maintaining internal controls;
- ▣ that they have designed such internal controls to ensure that material information is made known to such officers by others within those entities.
- ▣ that they have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report;

Disclosure Controls

Audit committee's responsibility for Section 302 (cont):

- ▣ that they have evaluated the effectiveness of the issuer's internal controls as of a date within 90 days prior to the report; and
- ▣ that they have presented in the report their conclusions about the effectiveness of their internal controls based on their evaluation as of that date;
- ▣ that they have disclosed to the issuer's auditors and the audit committee all significant deficiencies and material weaknesses in the design or operation of internal controls

Disclosure Controls

Audit committee's responsibility for Section 302 (cont):

- ▣ that they have disclosed any fraud, whether or not material, that involves management or other employees who have a significant role in the issuer's internal controls; and
- ▣ that they have indicated whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Sarbanes-Oxley Section 404(a)



The audit committee should provide oversight to testing of the effectiveness of internal control over financial reporting and financial statement preparation



COSO's 2006 Guidance,

Sarbanes-Oxley Section 404(a)

The board's [or Audit Committee's] role is one of governance, guidance and oversight. For publicly listed companies, the board's responsibilities may be mandated by law, listing-exchange requirements or charter [*such as Sarbanes-Oxley Act Section 404(a)*]



COSO's 2009 Guidance on Monitoring Internal Control Systems

[emphasis added]

Sarbanes-Oxley Section 404(a)

What is a SOX 404(a) assessment?



- Requires management to assert on the effectiveness of internal control over financial reporting as of its balance sheet date.
- Requires a “separate evaluation” of internal control that supplements the knowledge management has from its continuous monitoring activities.

Sarbanes-Oxley Section 404(a)

What is a SOX 404(a) assessment?



- Requires sufficient evidence from their own testing to know that all of its components of internal control, including the monitoring component, are working effectively.
- Requires enough of a separate evaluation as of the balance sheet date to know that its internal control over financial reporting is working effectively at that point in time.

Sarbanes-Oxley Section 404(a)

Audit committee responsibilities are defined under three attributes of oversight roles regarding monitoring.

1. **Monitors Risk** — Has the audit committee (or a competent and objective evaluator within management or outside party) actively evaluated and monitored risks of management override of internal control and considers risks affecting the reliability of financial reporting?



Sarbanes-Oxley Section 404(a)

Audit committee responsibilities are defined under three attributes of oversight roles regarding monitoring.

2. Oversees Quality and Reliability — Has the audit committee provided oversight to the effectiveness of internal control over financial reporting by ensuring a management assessments of internal controls over the financial statement process was properly documented and tested?

Sarbanes-Oxley Section 404(a)

Audit committee responsibilities are defined under three attributes of oversight roles regarding monitoring.

3. Oversees Audit Activities — Has the audit committee overseen the work of internal auditors and its responsibilities for meeting internal control related regulatory requirements, such as Sarbanes-Oxley Act Section 404(a) as necessary?

Sarbanes-Oxley Section 404(a)

Audit committee's oversight responsibilities for financial reporting and internal controls leading to good financial reporting:

- ▣ Understand the key accounting principles and complexities
- ▣ Understand the key internal accounting
- ▣ Understand IT controls that support the acctg infrastructure
- ▣ Understand the reporting risk areas.
- ▣ Understand levels of authority and responsibility

Financial Expert Poll Questions



Internal Controls over Financial Reporting

Audit Committee Charter



Sample audit committee charter responsibilities (ICFR)

- To review any Section 302 disclosures from the company's CEO or CFO made in connection with the certification of the company's quarterly and annual reports filed with the SEC [for instance significant deficiencies, material weaknesses, fraud) [Sarbanes-Oxley Act Section 302].
- To review the organizational structure of the internal audit function, as well as the qualifications of its personnel.

Audit Committee Charter

Sample audit committee charter responsibilities (ICFR)

- To oversee the company's compliance with legal and regulatory requirements including SOX Section 404(a).
- To gain understanding of the scope of the internal and independent auditors' review of internal control over financial reporting and to obtain reports on significant findings and recommendations, together with management responses.

Audit Committee Charter

Sample audit committee charter responsibilities (ICFR)

- To review changes in internal controls over financial reporting and any special audit steps adopted in light of material control deficiencies [Sarbanes-Oxley Act Section 302].
- To exercise authority to conduct investigations into any matters within its scope of responsibility to perform its duties and responsibilities [Sarbanes-Oxley Act Section 301]

Audit Committee Charter

Sample audit committee charter responsibilities (ICFR)

- To review the adequacy of the company's financial statement disclosures
- To review internal controls with independent auditors
- To review and/or approve all related-party transactions.

Audit Committee Charter

Sample audit committee charter responsibilities (ICFR)

- To oversee procedures for the treatment of whistleblower complaints regarding accounting, internal accounting controls [Sarbanes-Oxley Act Section 301]
- To oversee or be updated on the company's code of business conduct and ethics and its system to monitor ethical values.
- To actively monitor management's ability to override the company's internal controls.

Audit Committee Calendar of Events



Review of Financial/Controls Information	SEC	NYSE	NASDAQ	Best Practice
Review the internal controls report required under Section 404 of the Sarbanes-Oxley Act.	○			
Review management certifications required under Sections 302 and 906 of the Sarbanes-Oxley Act.	○			
Review the regular internal reports to management prepared by the internal audit function and management's response.				○



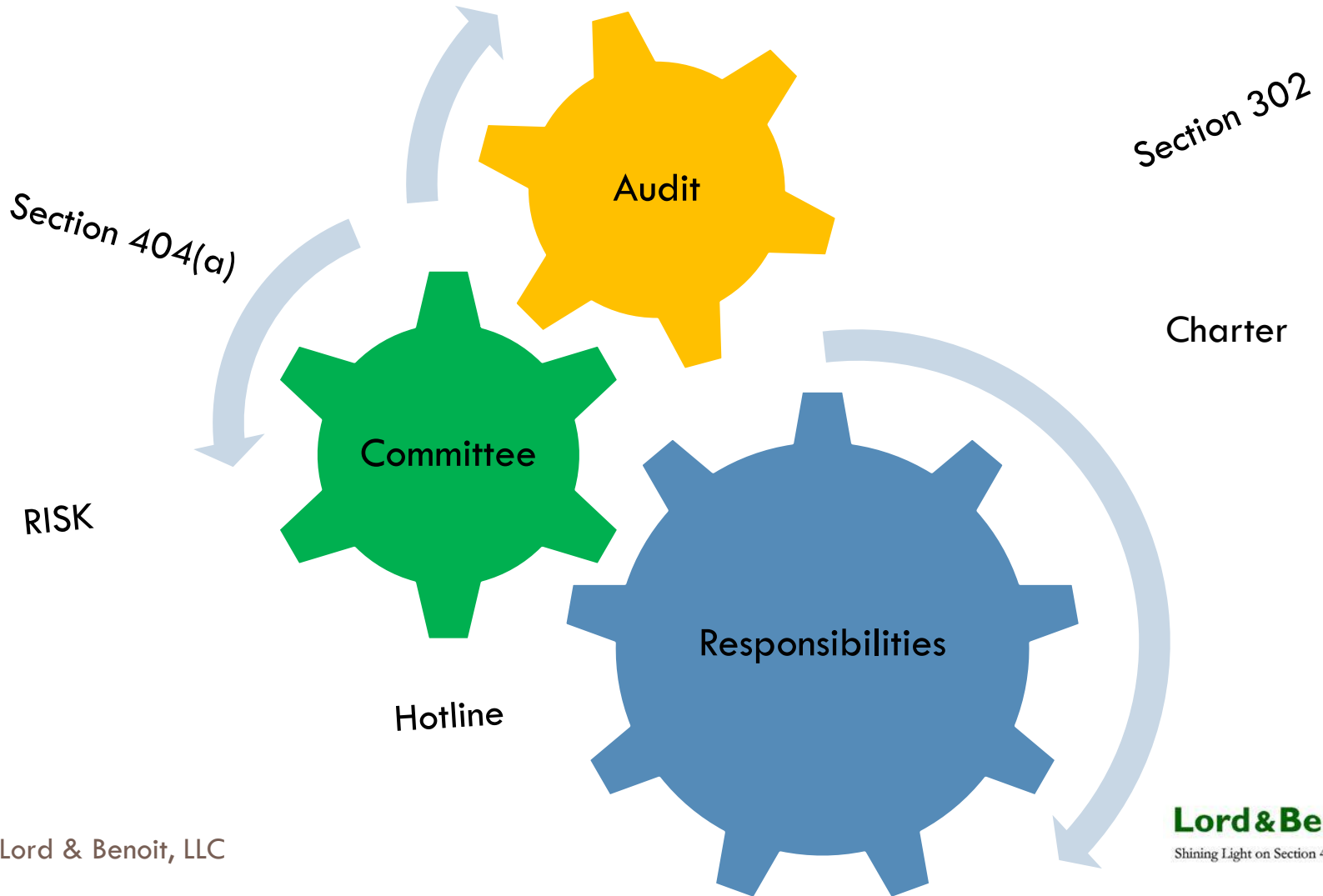
Source: Deloitte: Audit Committee Resource Guide

www.deloitte.com

Review

Expert

Internal Audit



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Shining Light on Section 404 Compliance

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