Cultivating World Class Audit Committee Relationships

Warren W. Stippich, Jr.
Partner and National Governance, Risk and Compliance Solution Leader
Business Advisory Services
Grant Thornton LLP

Raymond Panza
Retired CFO SPSS and Active Audit Committee Chair of Other Companies

Agenda

- Audit Committee Roles and Responsibilities
- Five Key Areas of Focus
- Tips for Increasing the Effectiveness of Audit Committee Meetings
- Q&A and General Discussion

The Challenges of an Audit Committee Member

- What are some of the challenges you've seen audit committees face over the past year?

The Audit Committee's Charge

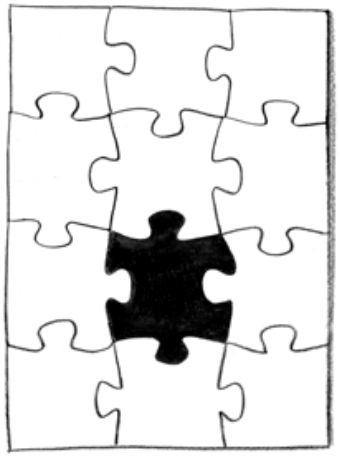
Responsible for:*

- **Overseeing accounting, internal controls** and financial reporting processes
- **Appointment, compensation and oversight** of independent registered public accounting firm
- **Resolution** of disagreements
- **Whistleblower** program (and considering Dodd-Frank Act)

* Source: SOX 205 & 301

The Challenges of an Audit Committee Member

- Increasing complexity of accounting and financial reporting
- Understanding intricate transactions
- Regulatory examinations
- SEC matters
- Risk Management (ERM)
- Society expectations
- Increasing focus on appearance as well in fact to be as board member and AC member



A Part-time Job with Full-time Responsibility

- Today's Audit Committee members have a **part-time job** that carries **full-time responsibility**.
- Additional responsibility carried by the designated financial expert.
- Determining whether Management is performing appropriate monitoring of events occurring below the Audit Committee.
- Challenged by the **"uncertain weight"** of regulation.

Summary of responsibilities

- All of this may seem quite daunting on paper – and to be sure, the effort involved is extensive – but the idea is relatively universal that **such independent checks and balances should be in place.**

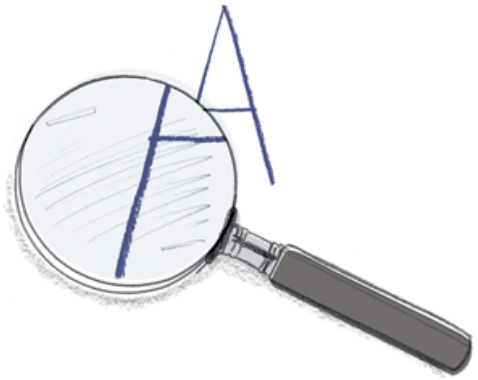
- **Document responsibilities**
- **Document processes**
- **Document compliance**

Summary of responsibilities

- 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, ensuring that those capital providers receive **complete, accurate and timely financial information** that has been subjected to an appropriate level of scrutiny.

Contributing to the Effectiveness of Your Audit Committee

Five Key Areas of Audit Committee Focus



Five key areas of focus: Appropriate Skills – Accounting

1

- **Does the organization have the right accounting and financial reporting skills and related oversight in <u>all</u> key areas?**
- **Areas of accounting complexity might include:**
  - Accounting for loans
  - Derivatives and treasury transactions
  - Fair value considerations
  - Income tax accounting
  - Mergers, acquisitions, divestitures
  - Loan sales and securitizations
  - Variable interest entities and consolidation considerations
  - Compliance with contracts

Five key areas of focus: Appropriate Skills – Internal Controls

1

cont'd

- **Does the organization have the right internal control skills and related oversight in <u>all</u> key areas?**
- **Areas of internal controls complexity might include:**
  - IT
  - Operating in the cloud
  - Multi-national operations
  - Multi-national operations in emerging countries
  - ERP migration
  - Mergers, acquisitions, divestitures

Five key areas of focus: Internal Control Oversight

2

- **Does management have a reasonable basis for knowing that ICFR is designed and operating correctly?**
- **Has management:**
  - Established a good control environment
  - Identified and prioritized meaningful risks (including fraud)
  - Identified controls most important to mitigating those risks
  - Identified appropriately persuasive information regarding control operation
  - Designed appropriate monitoring procedures
  - Reported and corrected known control deficiencies?

Five key areas of focus: Auditor Oversight – External

3

- Does your independent registered public accounting firm have the **appropriate skill sets and commitment to properly address** the areas of greatest financial reporting risk?
- Will the audit partner be candid and honest regarding his or her assessment of company skills and attitudes? Are they truly providing the independent assessment you need?
- Is your CPA firm willing to stand up to management, if necessary?
- Is your CPA firm "sounding the alarm" too much?

Five key areas of focus: Auditor Oversight – Internal

3

Cont'd

- Is the Audit Committee having a regular dialogue with the CAE about the internal control environment?
- Does the internal audit group adhere to the IPPF and related IIA Standards?
- Has a QAR been undertaken?
- Can the CAE help the Audit Committee understand its role?
- Has ERM been undertaken?

Five key areas of focus: All Auditor Oversight – Internal 3

Cont'd

- Internal Auditors should:
  - Be able to express (at the beginning of the audit) **areas of greatest risk** and roughly **how they will audit them**.
  - Keep the audit committee abreast of the **status of those key areas** throughout the year.
  - **Describe the training and skill sets** of internal audit personnel who will audit key areas.
  - These topics should be demonstrated to the audit committee on a recurring basis.

Five key areas of focus: Resources

4

- **Does the audit committee have the right resources to reach conclusions about the financial reporting process?**
  - The external auditor **cannot** be the audit committee's (or management's) primary monitoring resource.
  - More and more, audit committees need effective internal audit skills and continuing education.
  - Is the internal audit function robust enough?
    - in-house resources
    - co-sourced resources
  - Is the AC investing enough in internal audit?

Five key areas of focus: Economics Behind Every Transaction

5

- **Does management understand the risks the organization faces and properly responded?**
  - Broad risks related to strategy, operations, financial reporting or compliance with laws and regulation
  - Management has to explain the economic reality behind a transaction and the appropriate accounting considerations
  - Unique risks such as those associated with complex transactions (e.g., derivatives, complex leveraged lease transactions, acquisitions, etc.)

Tips for Contributing to the Effectiveness of Your Audit Committee

What you can do to cultivate your relationship with the audit committee

Audit Committee Relationships
Grant Thornton's CAE Survey – Baseline

- **More than 300 CAEs surveyed responded that:**
  - 95% believe that internal audit is valuable to the audit committee
  - Emphasis on risk-monitoring activities and efforts that strengthen corporate governance oversight
  - Business planning, increased efficiency, and general business advice is of less value to the board right now.

Audit Committee Relationships
Grant Thornton's CAE Survey Baseline
(cont'd)

- Audit committees are always looking for more value-added discussions from the internal audit function.
- Providing the board with strategic insight, business improvement recommendations, and general business perspective should be areas of value growth for internal audit.

Audit Committee Relationships
Grant Thornton's CAE Survey – Audit Committee Relationship

- About three in four (75%) audit executives say they meet individually with audit committee chairs often, in person or by phone.
- Well over half (60%) meet up to five times a year with the chair of the audit committee outside of regular committee and board meetings.
- 25% of CAEs say they do not meet with the audit committee chairman outside of committee meetings at all during the year.

Audit Committee Relationships
Grant Thornton's CAE Survey – Conflict

- 52% of CAEs say they have to take matters to the audit committee that counter management's view.
- 89% are comfortable discussing issues with the audit committee that are inconsistent with management's position.
- Open line of communication between objective auditors and overseers at the board level can help provide a check and balance mechanism to prevent problems from growing.

Audit Committee Relationships
Grant Thornton's CAE Survey – Value

- CAE's are independent thinkers and doing what's right to uphold the profession and being the eyes and ears for the AC.
- Having the CAE report direct line to the AC helps to ensure that when difficult situations arise, the CAE will feel safe about not getting fired by management and will raise concerns that may run counter to management's thinking.

Tips for Contributing to Your Audit Committee's Effectiveness

- **Understanding what objectives your committee wants or needs to accomplish?**
  - Ensure the AC has a charter that is solid and that internal audit understands.
  - Consider holding monthly or semi-monthly calls with the committee or chair. Prepare the AC Chair ahead of time.
  - Anticipate first by planning ahead and understand secondly what's on his/her mind.
  - Are there specific topics he/she would like to include on the agenda?
  - Are there topics you can present?
  - Make yourself invaluable to the AC Chair by leveraging the AC Chair's time and effort.
  - Allow the AC enough time to review material. Minimum of 5 days including the weekend before the meeting.

Tips for Contributing to Your Audit Committee's Effectiveness

- **A strong audit committee follows the industry closely**
  - Keep members in the loop on:
    - Competitive environment
    - Industry trends
    - New regulatory or legislation matters
  - Shape the debate. Create a dashboard. Management can lead discussions on these topics. Typically management follows these same matters, but there can be breakdowns between what management follows and what the audit committee is following.
  - Is the AC and BOD getting enough exposure to the industry, the company operations, and training?

Tips for Contributing to Your Audit Committee's Effectiveness

- **A strong audit committee follows the organization closely**
  - New processes or internal controls instituted (including IT)
  - New lines of business and the related accounting aspects
  - Contemplated transactions and related accounting
  - Recently completed regulatory examinations
  - Upcoming regulatory examinations
  - Review management technical whitepapers

Tips for Contributing to Your Audit Committee's Effectiveness

- **For new or complex transactions**
  - Management should present clear background of the transaction, including appropriate detail.
  - What is the business purpose?
  - What is the appropriate accounting and why?
  - What financial statement disclosures will be needed?
  - Are there alternative accounting treatments (either other treatments available or those management considered)?
  - Is the auditor in agreement with management?

Tips for Contributing to Your Audit Committee's Effectiveness

- **For new or complex transactions**
  - Encourage the committee's members to discuss the following with the auditor:
    - What representations were obtained from management that led to the accounting conclusions?
    - Has the transaction been audited? If not, when will this occur?
    - What factors could be identified during the audit testing that could potentially lead to a different conclusion?
    - What could be the impact of a different conclusion?

Tips for Contributing to Your Audit Committee's Effectiveness

- **Common matters detracting from effectiveness**
  - Meetings without organization
  - Meetings following a fixed agenda without focus on the topics at hand.
  - What is the right level of detail?
    - Too much detail?
    - Too little detail?
  - Management is not supportive.

Tips for Contributing to Your Audit Committee's Effectiveness

- **Who should present at audit committee meetings?**
  - Typical participants include CFO, CAO, Controller and CAE, along with the External Auditor.
  - Others may include:
    - Regulatory and Compliance Officer/Director
    - Bank Security Officer/Director
    - IT Director
  - Valuable participants that may be missed
    - Divisional Controllers/VP's of Finance
    - Loan review function/Chief Lending Officer
    - Directors of other business lines (securities, insurance, etc.)
  - Some participants may only need to be on the agenda periodically. May not need to have a formal presentation if no events have occurred.

Tips for Contributing to Your Audit Committee's Effectiveness

- **During audit crunch-time or other "events" going on giving rise to more audit committee interaction**
  - Consider holding more frequent meetings
  - Status update on the audit:
    - Difficulties encountered to date?
    - Proposed adjustments to date?
    - Control deficiencies to date?
      - Identified?
      - Still open?
      - How resolved?
  - Document activities and actions

Q&A and General Discussion

Contact info

Warren W. Stippich, Jr.

Partner and Chicago Practice Leader

National Governance, Risk and Compliance Solution Leader
Business Advisory Services

T: 312.602.8499

E: Warren.Stippich@us.gt.com

Raymond Panza

Retired CFO SPSS and Active Audit Committee Chair of Other Companies

T: 847.842.0388

E: RHPanza@gmail.com

Grant Thornton

The Institute of Internal Auditors CHICAGO

www.GrantThornton.com