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# *Audit Committee Overload*

2007 NATIONAL DIRECTORS INSTITUTE

## AUDIT COMMITTEE OVERLOAD

Recent developments have resulted in an increase of the workload borne by the public company audit committee. Those developments include new issuer obligations as a result of Section 404 of the Sarbanes-Oxley Act; continuing restatements, fraud, errors, internal investigations and SEC enforcement proceedings; ongoing onslaught of new and complex accounting and financial reporting pronouncements; auditor independence rules; and, review and approval of related person transactions. The audit committee may now find itself filling a litany of new roles, including investigator, arbiter and advisor as to diagnosis and remediation of company problems, corporate monitor, and primary liaison with the SEC and other government organizations.

At Foley's sixth annual National Directors Institute on March 8, 2007 in Chicago, "Audit Committee Overload," was a featured breakout session. Moderated by Art Bill and Michael Matthews, partners at Foley & Lardner LLP, and Pat Condon, partner at Deloitte & Touche, the discussion examined ways in which audit committees can effectively manage its new and growing responsibilities. The breakout session also featured Jim Kackley, Herman Miller, Inc., Orion Energy Systems, Ltd. and PepsiAmericas, Inc.; Isaac Kaufman, Hanger Orthopedic Group, Inc., Kindred Healthcare, Inc. and Transworld Entertainment Corp.; Cheryl Mayberry McKissack, Deluxe Corp. and Private Bancorp, Inc.; and John Ryan, Hewitt Associates, Inc.

### Expanding Duties

Audit committees bear weighty responsibilities, which have only expanded and become more complex in recent years. In addition to its historical oversight of the integrity of the company's financial statements, compliance with legal and regulatory requirements, the independent auditor's qualifications, independence and performance, and performance of the company's internal audit function, recent developments have resulted in an increase in the oversight workload borne by the public company audit committee. Those developments include:

- The issuer's obligations relating to internal controls over financial reporting mandated by Sarbanes-Oxley (SOX) Section 404, without substantive guidance from the SEC
- The independent auditor's evolving advice regarding SOX Section 404
- Continuing restatements, fraud, and errors as well as internal investigations and related SEC enforcement proceedings
- Performance of the committee as, among other things:
  - investigator and reporter to the board and others
  - arbiter or advisor as to appropriate remediation
  - corporate monitor to ensure execution of a remediation or compliance plan
  - primary SEC Enforcement and other government liaison in all these roles
- The ongoing onslaught of new, complex accounting and financial reporting pronouncements, such as FIN 48, SFAS 158, SFAS 123R and SAB 108
- PCAOB auditor independence rules relating to the auditor's rendering of services
- For some audit committees, the review and approval of related person transactions.

## Practical Advice for Handling Increasing Responsibilities

Audit committee members must understand that the large workload comes with the role. Working on an audit committee is challenging, but if the committee understands the scope of its mandate, the work can be managed effectively.

Taking certain steps can help ensure that an audit committee fulfills its responsibilities. Most importantly, audit committee members must spend significant time with the key people employed in the key areas of the company such as the CFO and controller, especially when the directors first join the audit committee. Issues before audit committees have become so complex that audit committee members must assure themselves that they can rely on these key individuals, which requires spending time together outside of the meeting setting.

Additionally, boards of directors recently have begun to shift some of the audit committees' responsibilities to other committees in order to balance the "overload" situation. It can be helpful for committee members to work on audit committee issues prior to meetings; and some boards are now using private Web sites for posting and reviewing board and committee materials and information. Others also use presentations from company management, recorded on DVDs, to prepare for portions of meetings.

The main thing that can help audit committees succeed is to have high-quality personnel working for the company and for the independent auditors. The tone at the top is especially important. Practically speaking, responsibilities can be split between more traditional audit committee responsibilities and others delegated to a "quality and compliance committee." The two committees can hold joint meetings to consider issues related to risk management, internal investigations, or other legal issues before breaking off into separate meetings.

In addition to the presence of quality personnel in company management, it is important for the members of the committee to be talented and have the right experience. The audit committee of Deluxe Corporation, for example, is composed of two sitting-CFOs and the chair of the company's finance committee. Each board member on the committee volunteered their service and are therefore interested, engaged and willing to take the time to handle the audit committee's increasing responsibilities.

## Getting Organized

One key to an effectively functioning audit committee is organization. Among other things, the committee should have (1) a clearly-articulated calendar, which it rigorously adheres to; (2) materials available to it more than twenty-four hours prior to each meeting; (3) its meeting on a different day than the board meeting, giving it its own time to consider and deliberate issues, whether or not on the agenda; and (4) pre-meeting preparation by the chair-person. Preparation by all members, especially the chairperson, facilitates the functioning of the committee as a whole. Separating the review of company filings and related documents (which can be discussed outside of the meeting setting, or even just through the committee chairperson) from other committee activities during meetings can facilitate workload management.

## The Effect of SOX 404 on Audit Committees

It is fair to say that SOX 404 has complicated the lives of audit committee members, especially during the period when auditors and companies were first getting acquainted with their new obligations. Once through the first review cycle, however, the company and the committee can develop techniques for handling SOX 404 issues in the future to make the review much more manageable.

From an auditors' perspective, the implementation of SOX 404 has become more familiar, but not completely routine. For example, audit committees now often are focused on whether the company is tracking too many controls. There had been an almost maniacal pursuit of eliminating all weaknesses on behalf of many public companies and auditors, who now have a better understanding of what their real risks are and how those translate into weaknesses and deficiencies.

Audit committees have gone through a learning process, and may be spending a tremendous amount of time on internal controls testing and working with the independent auditors. The accounting and auditing firms themselves have experienced the steepness of the learning curve and have had to engage in some experimentation themselves.

## Audit Committees and Internal Investigations

Regarding the audit committee's role in connection with internal investigations and responding to reports of fraud or whistleblower / hotline calls, an emerging trend is that in which audit committees are acting as corporate monitors after internal investigations have been completed, to ensure that remediation of weaknesses or deficiencies is actually occurring and is effective (and to assure government enforcement officials accordingly). For example, Prudential Financial recently settled a market timing case with the U.S. Attorney's office in Boston that required the audit committee to take on the corporate monitor role and oversee the company's general counsel on the progress of the remediation, including reports at least twice a year for the next five years to the U.S. Attorney in Boston.

The audit committee should triage the investigations it becomes involved with; it should limit itself to topics such as financial reporting and internal controls. It may be necessary to report other misconduct to the board, but that does not make an audit committee-led investigation a forgone conclusion. Should the audit committee become involved with an investigation, it should begin thinking very early on in the process about whether the situation warrants the involvement of external advisors. The SEC and the courts have been inclined to view audit committees as the appropriate monitoring bodies because they have established networks of outside service providers, such as auditing firms.

## Training New Committee Members

The pace with which accounting and financial reporting pronouncements are changing seems to be accelerating, causing the audit committee to adjust its member-training practices. Auditing firms and other organizations publish timely guidance on new pronouncements, but what the panelists' experience has been in connection with the training offered for audit committee members is unknown.

Again as an example, Deluxe Corporation utilizes a formal training program which is individualized for each new director. When a director joins the board, the board collectively designs a customized training program in which the member can sit down one-on-one with executive leadership and discuss selected issues. The audit committees also have individualized training in which the members visit the company's facilities, meet with financial, internal and external audit and compliance personnel and even work at the facility for a week.

Another of one of the panelist's boards requires every director, especially committee chairpersons, to attend continuing education classes annually, and a number of classes are designed to target the specific responsibilities of audit committees and audit committee chairpersons.

Audit committees should utilize the engagement partner for the independent auditors as the first line of defense in keeping up with new accounting and financial disclosure pronouncements. The partner should keep the committee well-informed of new developments and provide summaries of recent accounting bulletins. The committee may also engage internal or external counsel in tracking new information and educating the committee in an efficient, but meaningful way.

Also, succession planning is not just for company management. Boards of directors should have a rotation schedule for committee service, discuss future service and begin the process of educating future members of audit committees as early as possible. Still, the need exists to balance the required level of sophistication of audit committee members, with the need to avoid micromanagement of the company's business. Committee members should be knowledgeable but, as is the standard with the board of directors, which does not manage the day-to-day business of the company, the audit committee should not do so either. Audit committees must have full confidence in the ability of management and should rely on the company and the company's auditors.

**Risk Management by the Audit Committee**

In addition to traditional accounting and financial reporting risks, companies must plan and manage for all major risks facing a company, such as terrorism, natural catastrophes, pandemic, sourcing, and technological risks. Some audit committees oversee just the financial reporting and regulatory compliance risks, some oversee all major risks. Greg Case, CEO of Aon Corporation, recommends that every company be able to identify the top five risks facing it and develop a plan to address and remediate those risks. In this vein, the audit committee should put pressure on management to take risk evaluation and remediation process seriously, ensuring that both financial and operational risks are examined equally. One method for risk evaluation is to assign certain risks to individual officers or departments who should then develop an action plan for mitigating that risk and report back to the audit committee regarding the plan.

Audit committee responsibilities often vary. Some oversee the evaluation of all risks, while others are relieved of non-financial risk management responsibilities by the chairman of the board, who reassigns that work to the board as a whole. Additionally, risk management often is divided among the board's committees, with more traditional accounting and financial reporting risks falling to the audit committee. Many companies believe that the board as a whole is the correct place for the evaluation of all major risks because if risk management is not handled properly, certain seemingly benign risks can evolve into more serious accounting, financial reporting or even going-concern risks.

Once a company has identified an issue as a business risk, the company must evaluate possible cautionary language related to that risk in its future earnings releases and financial statements.

**Engaging an Independent Auditor**

The most important factor in engaging an independent auditor is the caliber of the engagement partner. The audit committee should evaluate the engagement partner's understanding of the relevant industry, knowledge of important pronouncements and risks, and service philosophy. Ultimately, it is the prospective engagement partner presented by the firm that companies focus on in deciding upon an engagement.

## For More Information

For more information on this session or the sixth annual National Directors Institute, visit Foley.com/ndi2007 or contact the panelists directly.


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Save the date! The 7th Annual National Directors Institute will be held on March 6, 2008 in Chicago. Learn more at Foley.com/ndi.