FOLEY

FOLEY & LARDNER LLP

# *Audit Committee Trends*

2008 NATIONAL DIRECTORS INSTITUTE


# AUDIT COMMITTEE TRENDS

## INTRODUCTION

"Audit Committee Trends" was a featured breakout session at the seventh annual National Directors Institute hosted by Foley & Lardner LLP on March 6, 2008, in Chicago. The session was moderated by Foley Partners Arthur H. Bill and Michael P. Matthews as well as Barry Franklin of Aon Global Risk Consulting and Richard Herlin of Deloitte & Touche LLP. Panelists included Michele Hooper of The Directors' Council; James Kackley of Orion Energy Systems, Inc.; and Isaac Kaufman of Hanger Orthopedic Group, Inc.

The discussion highlighted audit committees' experiences with the Sarbanes-Oxley Act (SOX) Section 404 and the Public Company Accounting Oversight Board (PCAOB) Auditing Standard No. 5. Panelists examined how audit committees address an array of recurring quarterly review and inquiry responsibilities; audit committee meetings and logistics; the role of audit committees in the oversight of risk management; and retention of counsel for internal investigations with corresponding attorney-client privilege issues.

## IMPACT OF PCAOB AUDITING STANDARD NO. 5

Public companies that are "nonaccredited filers" with calendar fiscal years just completed their first year of including a SOX Section 404 management's report on internal control over financial reporting in the Form 10-K. Next year, such filers also will be required to include an auditor's attestation regarding the internal controls. The "accelerated filers" have been including both the management's report and auditor's attestation in the 10-K for four years. During 2007, the PCAOB issued Auditing Standard No. 5, superseding Auditing Standard No. 2, and the U.S. Securities and Exchange Commission (SEC) provided guidance to issuers regarding the establishment and maintenance of internal controls. The intent behind the issuance of Auditing Standard No. 5 was to decrease the costs of SOX Section 404 compliance, to reduce the time spent by the issuers on internal control over financial reporting, and to allow greater reliance on outside auditors.

The consensus at the breakout session was that Auditing Standard No. 5 has been received positively by audit committees. The previous regulatory regime was confusing, inflexible, overly burdensome in terms of costs, required completion of duplicative tasks, and resulted in tremendous inefficiencies. Auditing Standard No. 5 emphasizes increased flexibility and allows for greater use of risk-based judgment, which in turn lowers the number of controls an issuer must review. The emphasis on judgment allows an issuer to perform the internal controls inquiry in cycles as opposed to performing identical tasks on an annual basis. Issuers are moving forward with a risk-management approach, which requires more rigorous testing of the high-risk processes and less testing of the low-risk processes.


 

At the same time, the quality of the establishment and maintenance of internal controls has not decreased. The consensus has been that Auditing Standard No. 5 has saved larger issuers an average of 10 percent to 15 percent in audit fees, while smaller issuers are realizing an average saving of 4 percent to 6 percent in audit fees.

## AUDIT COMMITTEE ORGANIZATION AND HANDLING OF GREATER RESPONSIBILITIES

The responsibilities of audit committees have increased significantly in recent years. Among other duties, these include review of quarterly and annual filings and earnings press releases; preparation of the year-end financial statement audit and SOX Section 404 internal controls reporting; and periodic meetings with management, outside auditors, internal auditors, general counsel, and — increasingly — a representative of the issuer's disclosure committee. Nonrecurring transactions (e.g., material mergers and acquisitions (M&A) transactions, debt restructurings, and equity offerings) also require audit committee oversight involvement. Recently, audit committees have become more involved in the general oversight of the risk-management process.

Audit committees have taken a variety of steps to streamline their agendas in order to perform their responsibilities without an excessive number of formal meetings. These steps include the following:

- Conducting several telephone meetings during a quarter, with at least one meeting focused on a specific topic
- Shifting responsibilities to other committees where appropriate
- Creating at the beginning of the fiscal year a responsibilities calendar that exactly identifies tasks that need to be performed, and cross-checking the calendar with the audit committee charter to ensure all tasks identified in the charter are being performed during the fiscal year
- Meeting with an internal auditor at the conclusion of a committee meeting to determine whether there are any issues on which the committee needs to take action, including but not limited to allocation of resources, staffing, and external audit considerations such as turnover and succession
- Conducting "deep-dive" sessions with management on a particular issue affecting the issuer's business and inviting all members of the board to participate
- Conducting shared sessions with other board committees and having members of the audit committee sit on the meetings of other committees
- Insisting on receiving materials from management sufficiently in advance of a meeting to become thoroughly familiar with the materials, and asking probing questions of management

Audit committees also should take steps to ensure that their members participate in continued education. For most audit committees, this is a formal process that includes, among other things, identification of topics at the beginning of the fiscal year, invitation of outside experts to committee meetings to make presentations, and encouragement of committee members to sign up for outside seminars and classes on topics of interest.

## AUDIT COMMITTEE'S ROLE IN THE OVERSIGHT OF ENTERPRISE RISK MANAGEMENT

The level of an audit committee's involvement in the oversight of enterprise risk management depends on the size of an issuer. Audit committees of smaller issuers generally do not have substantial involvement, whereas audit committees of larger issuers find themselves becoming increasingly more involved with the issuer's disclosures associated with significant business risks — financial, operational, strategic, and others.

The key function of the audit committee in this area is to identify issues that may negatively affect the company. Oftentimes the role of the audit committee is to make sure that the management has in place a process to examine enterprise risk issues. Audit committees use a matrix of risks, including financial risks, to track individual processes and to report to the full board. Audit committees invite top managers to give a thorough presentation of the issues relating to company's core businesses (e.g., controller and chief operating officer making a presentation on accounting and other issues affecting the company's supply chain). Audit committees also regularly receive reports from the company's disclosure committees and have members of the company's disclosure committees sit in on audit committee meetings.

## INTERACTION OF AUDIT COMMITTEES WITH OUTSIDE COUNSEL

The Delaware Court of Chancery recently ruled in *Ryan v. Gifford* that by disclosing findings of the special committee to the full board, including several directors whose conduct was at issue and whose attorneys were attending the presentation, the special committee waived the attorney-client privilege and the work-product privilege with respect to materials reviewed by the special committee and communications between the special committee and its counsel.

Audit committees do not regularly engage their own separate outside counsel. If an internal conflict is not perceived, audit committees interact with the general counsel and expect such communications to remain privileged and confidential. If an internal conflict is perceived, audit committees hire separate counsel and do not share — without advice from their own counsel about the potential impact on privilege — the counsel's report with third parties.

**FOR MORE INFORMATION**

For more information on this session or the seventh annual National Directors Institute, visit Foley.com/ndi or contact the moderators and panelists directly.

Arthur Bill
Foley & Lardner LLP
abill@foley.com

Barry Franklin
Aon Global Risk Consulting
barry_franklin@ars.aon.com

Richard Herlin
Deloitte & Touche LLP
rherlin@deloitte.com

Michele Hooper
The Directors' Council
michele@directorscouncil.com

James Kackley
Orion Energy Systems, Inc.
jkackley@mhtc.net

Isaac Kaufman
Advanced Medical Management, Inc.
ikaufman@amm.bz

Michael Matthews
Foley & Lardner LLP
mmatthews@foley.com