Audit Committee *Brief*

Select a topic

In this complex and ever-changing business environment, the demands on audit committees have never been more challenging. The depth and range of the audit committee's duties are greater than ever, and it has become increasingly important to prioritize the agenda and allocate time appropriately. While the responsibility to oversee financial reporting and compliance and to monitor management activities remains fundamental, items such as information technology, regulatory matters, globalization, risk oversight, and tax issues have recently played a significant role in many audit committees' activities, and this is likely to continue in 2015.

This edition of the *Audit Committee Brief* highlights several prominent and timely issues likely to be high priorities for audit committees in 2015, and provides considerations and questions to ask regarding these topics, as well as resources for further information. Included throughout this issue are insights from Deloitte's 2014 Audit Committee Symposium: *Prepare. Prioritize. Execute.*, where senior governance leaders shared their perspectives on important topics for audit committee members in the coming year.

Additional resources

Audit Committee Brief, May/June 2014: Technology at the Forefront

Audit Committee Brief, March 2013: Understanding the CFO and CIO dynamic

For Audit Committees, a Growing Role in Cybersecurity

The Dual Roles of the CIO in the Digital Age

Changing the Game on Cyber Risk: The Imperative to Be Secure, Vigilant, and Resilient

Effectively managing IT

Technology is an increasingly high priority for most companies, and its influence on all aspects of business is certain to expand in the coming years. Cybersecurity, social media, cloud strategies, and big data are no longer fringe investments to be managed by the IT function; they are among the topics regularly being discussed in board and audit committee meetings across industries, and they are often the focal point for innovative efforts that can potentially mitigate or increase risk, depending on the effectiveness of oversight and controls.

Given the rapid pace of change, committee members may find it difficult to keep up with developments in these areas. The audit committee needs to have access to up-to-date information that is provided at the appropriate level of detail. In order for this to occur, it is important for the audit committee to develop a relationship with the IT leader(s) for the company. Having periodic meetings with the IT leader(s) is especially important, given that the landscape of potential investments, tools, and risks can substantively change over a period of just a few months.

Many companies have a chief information officer (CIO), and in some cases a chief information security officer (CISO), who has primary responsibility for IT-related matters. While the CIO position has been around for many years, a universally applicable reporting structure has not yet been identified. In some cases, CIOs report to the CFO, while others may report to the CEO or COO to directly advocate for the importance of IT at the company. Additionally, there is debate regarding whether the CISO should be independent from IT and the CIO, and report directly to the COO or CEO. There is not a one-size-fits-all approach that covers all companies and industries.

Whatever the most appropriate structure may be, it is important that boards and audit committees understand the reporting line and who has primary responsibility for technology issues. Being comfortable with the information that is being received helps the audit committee be comfortable with the sufficiency of, and approach to, the company's practices.

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Mary Galligan

Mary Galligan, director, Cyber Risk Services, Deloitte & Touche LLP, and former FBI special agent in charge, Cyber and Special Operations, noted during Deloitte's Audit Committee Symposium that the effective prevention of, and reaction to, cyber threats are vitally important. Galligan said that companies need to have a clear plan of action and a chain of command for cybersecurity issues, because there will be no time to get organized once an incident occurs. She added that it is important to facilitate planning sessions that bring both technology and business professionals together to explore related issues and appropriate responses.

Galligan said, "A cyber breach will be a technical issue for about five minutes; it's everything that comes after—the hours, the weeks, the months—that will be the actual incident."

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Speaking at the Audit Committee Symposium, Jonathan Zittrain, computer science and law professor at Harvard University, highlighted how social media is changing the way companies connect with consumers. He said, "Every interaction someone has with a customer-facing or retail-facing corporation is going to be subject to later instant-replay review, making every employee much more directly representative of the company in the public's eye."


Jonathan Zittrain

He also emphasized the importance of mitigating risk through resilience and not just prevention. "It's really hard to prevent problems, to have every single employee be at his or her best at all times," he said. "Being able to respond in a way that does justice to the problem that has come up is going to be the name of the game."

Questions for the audit committee to consider:

- Is it known what information is leaving the company?
- Should extra precautions be put into place to avoid cyber attacks on senior executives?
- Is there a clear chain of command and response plan in the event that there is a cyber attack or a social media incident?

Audit committees and the regulatory environment

During the Audit Committee Symposium, Joe Ucuzoglu, national managing partner, Government, Regulatory, and Professional Matters, Deloitte LLP, said, "We are clearly experiencing a shift in the regulatory pendulum, and I don't see any signs of that abating. I do see companies starting to settle into this new environment and adapt to it, and to grow and innovate within the confines of expanded regulation." Along these lines, some of the regulatory focus has shifted to the audit committee and its role in being empowered and setting the tone that the audit committee is the primary overseer of the auditor and that the auditor should communicate directly with the committee when there are issues.

Regulators continue to solicit the views of audit committees and have been encouraging committee members to be actively involved in regulatory matters affecting their companies. The PCAOB, for example, has stated as a near-term priority enhancing its "outreach to and interaction with audit committees to constructively engage in areas of common interest, including auditor independence and audit quality."

This section highlights recent regulatory developments and includes numerous links to additional resources. For further information, see the July 2014 issue of the *Audit Committee Brief*, which covers in detail a wide range of domestic and global regulatory issues and discusses how audit committees can enhance their involvement.

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At the Audit Committee Symposium, Joe Ucuzoglu noted that in the audit committee report, some companies have started to add disclosures that reaffirm the Sarbanes-Oxley framework whereby the audit committee is directly responsible for the appointment, compensation, and oversight of the independent auditor. He said there has also been a trend toward audit committees explaining more about what they do to accomplish these responsibilities.


Joe Ucuzoglu

Additional resources

Heads Up, September 5, 2014: Challenges and Leading Practices Related to Implementing COSO's Internal Control—Integrated Framework

Audit Committee Brief, July 2014: Update on Regulatory Issues Affecting Audit Committees

Audit Committee Brief, February 2014: A New Era in Audit Committee Reporting

Audit committee report

There has been considerable discussion among regulators and stakeholders regarding the benefits of increased transparency from the audit committee about the committee's responsibilities, including the oversight of the independent auditor and other key duties. At the October 20, 2014, meeting of the PCAOB's Investor Advisory Group, there was significant discussion of the audit committee's role. In her comments at the meeting, SEC Chair Mary Jo White said, "You can't overstate the importance of the audit committee functioning at the highest possible level." She added that the SEC staff is developing a concept release that will address the audit committee report, and that the SEC may request public comment in early 2015.

Investor groups such as the Council of Institutional Investors (CII) and the United Brotherhood of Carpenters and Joiners of America have expressed a desire for more information about how the audit committee executes its duties. One way for audit committees to respond is by providing clear, concise, and thorough disclosures regarding their activities that can enhance the understanding of their responsibilities and how individual committees carry them out, and provide confidence that the audit committee is functioning to protect investor interests. The February 2014 issue of the *Audit Committee Brief* discusses in more detail the efforts of organizations such as the CII and the Center for Audit Quality to promote audit quality and help audit committees effectively enhance disclosures.

Internal controls

Regulators are devoting significant attention to issues related to internal control over financial reporting. In inspection reports over the past few years, a sizable percentage of the PCAOB's findings have been related to internal controls. Additionally, in reviewing issuers' filings, SEC staff members continue to focus on whether issuers are properly identifying and disclosing material weaknesses in internal control over financial reporting, particularly with respect to immaterial restatements. In accordance with SEC guidance, an issuer is required to consider the potential error that could have occurred as a result of a control deficiency, rather than just the actual error, when assessing the severity of the deficiency.

There has also been a focus by the PCAOB on the auditor digging deeper and testing the reports or other information used in performing control activities, as well as the systems used to produce these reports. Management's responsibility for the quality and integrity of the data used for control purposes is also a focus in the 2013 Committee of Sponsoring Organizations of the Treadway Commission (COSO) Framework (see below for more information).

In addition to overseeing internal control over financial reporting, many audit committees are taking on oversight responsibilities related to other compliance and operational matters. The audit committee should work with management and the independent auditor to make certain that the appropriate internal controls are in place and properly documented across all relevant areas of the business.

COSO Framework

The 2013 COSO Framework has been modernized, with an increased focus on topics such as:

- The importance of a thoughtful risk assessment process, including considering fraud risk and identifying changes that affect the risk assessment
- IT controls, including controls over the quality of information and data used to carry out internal control procedures and responsibilities
- Considerations regarding appropriate controls over outsourced service providers.

As of December 15, 2014, COSO considers the 1992 Framework to be superseded[1]. Implementing the new framework provides companies and their audit committees with an opportunity for a fresh look, as well as a means to objectively reevaluate their internal controls to identify both areas for improvement and synergies.

Questions for the audit committee to consider:

- Is the audit committee positioned to be actively engaged in the organization as a leader in overseeing the audit process?
- Are the disclosures provided in the audit committee report appropriate and sufficient?
- What regulatory issues are most important to the organization, and has the audit committee's voice been heard on these matters?
- What potential internal control issues has the new COSO framework raised, and how can they best be addressed?

Globalization

When considering the ever-expanding role of audit committees, globalization is often top of mind for those committee members whose companies continue to expand their operations across borders. Traditional business models are changing rapidly, and the operational approaches that sustain them need to be adjusted to better align with the organization's goals. Each country or region has its own unique legal, cultural, and business environment, which increases the associated risks and complexities. Audit committee members can benefit from understanding the global environment in which the company is operating in order to help guide decision-making, risk-related determinations, and oversight activities.

1 SEC rules state that "the framework on which management's evaluation of the issuer's internal control over financial reporting is based must be a suitable, recognized control framework that is established by a body or group that has followed due-process procedures, including the broad distribution of the framework for public comment." See 17 CFR §§ 240.13a-15(c).

Additional resources

Audit Committee Brief, August 2014: Finance Talent: Building Sustainable Leadership

CFO Journal: Talent: Building the Team You Need Now

Audit Committee Brief, October 2013: Navigating Anti-corruption Compliance

2014 Q2 Global CFO Signals: Wanted: Political & Regulatory Clarity

CFO Journal: Why Globalization Demands Chief Frontier Officers

Deloitte 2013 Global Finance Talent Survey

Finance talent

The challenges and opportunities of globalization are redesigning the finance landscape, and this is leading to new talent needs. There is concern at many large companies about recruiting, retaining, and developing talent in their global finance organizations. In a recent Deloitte survey of finance executives around the world, 92 percent said talent was an important issue, with 34 percent indicating it was their top concern. Further, 40 percent of respondents were not optimistic about their ability to meet talent demands in the future[2].

Talent retention and succession planning in a global environment go beyond the customary considerations in the domestic context. When evaluating global finance talent needs, companies may want to consider culture, personality, work ethic, and regulatory regimes, among other issues. Structural considerations related to shared-service approaches and outsourcing further complicate issues of pipeline, continuity, and quality control. The constantly expanding roles of key executives, including the chief financial officer, add further complexity to talent development and succession planning, as the candidates need opportunities to gain experience across a broader array of business issues. Audit committees can assist in making sure plans to build a strong global finance talent team keep moving forward. Committee members may wish to discuss with senior management the potential need for a different strategy when promoting, recruiting, and retaining talent in other cultures.

Anti-corruption compliance

Corruption risk is among the most complex and challenging issues with which large, global companies must contend. Issues can potentially arise from a variety of sources, including employees, affiliates, and suppliers. Given that criminal activity can have an outsized effect on organizations beyond traditional measures of materiality, even seemingly small issues can pose significant risk, both financially and reputationally.

Audit committees are often tasked with evaluating management's compliance program related to minimizing and mitigating corruption issues. As part of this role, the audit committee should have an awareness of the U.S. Foreign Corrupt Practices Act and other non-U.S. anti-corruption laws that may be applicable (e.g., the U.K. Bribery Act of 2010), as well as an understanding of the overall process by which business is transacted in countries where the organization has significant operations. Confirming that there is a well-designed and overseen compliance program that is responsive to the company's risks and consistent across geographies can reduce uncertainty and minimize the risk of legal and financial repercussions.

Questions for the audit committee to consider:

- Who has responsibility for evaluating and communicating the risks associated with commencing business in a new country or region?
- Is there a finance talent strategy in place in the organization, and does it address the unique considerations associated with talent recruitment, retention, and succession in the global context?
- How are the audit committee and board brought up to speed on the various dimensions of major transactions and other deals with a global footprint?
- Do management and the board have a clear understanding of how the various vendors, affiliates, and other participants in the global business are overseen?

2 Deloitte 2013 Global Finance Talent Survey.

Additional resources

Risk Intelligent Governance: Lessons from State-of-the-Art Board Practices

Risk Intelligent Proxy Disclosures – 2013: Trending Upward

As Risks Rise, Boards Respond: A Global View of Risk Committees

Risk oversight

Risk oversight has always been a high priority for boards and audit committees. While the audit committee's primary focus has been on overseeing the process for identifying and addressing financial risks, additional risks have increasingly come under the committee's purview in recent years.

Some companies conduct risk oversight at the audit committee or full-board level, while others, principally those in financial services, have a separate risk committee. Regardless of who in the company is in charge of risk, the most important consideration is that the company has a clear view of where risk monitoring and related activities are housed and that risk issues are being adequately covered. Along these lines, all board members should keep abreast of the most significant enterprise-level risks to the organization so that they can confirm that they are being addressed effectively and provide input as appropriate.

An appropriate and consistent tone at the top is imperative to successful risk oversight. A problematic business culture not only allows for the possibility of ongoing or emerging risks going unnoticed, but also can create new risks that might not otherwise have arisen. The audit committee and board play a key role in identifying such unhealthy situations, which could include instances where management may not be adequately considering strategic risk issues, or where individuals, including senior leaders, may be pursuing personal goals to the detriment of the organization.

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At the 2014 Audit Committee Symposium, Charles Strauss, chairman of the Finance, Investment, and Risk Management Committee and member of the Audit Committee for The Hartford Financial Services Group, noted, "Whether through a risk committee or an audit committee, educating board members on particularly important risks, particularly those that that are strategically or fundamentally or operationally important to your business, is a good use of time."


Charles Strauss

Alfred F. Kelly Jr., audit committee member of MetLife and New York Presbyterian Hospital and board member of Visa, added, "You can't have risk and quality and operational risk elements as a staff function; if you're really committed to them, these mechanisms need to be deeply embedded in the company to have the best chance of any kind of risk being mitigated."


Alfred F. Kelly Jr.

Questions for the audit committee to consider:

- Is there a clear approach and justification for where risk issues are housed and how they are allocated?
- In the event that risk-related issues arise, is there an effective and widely communicated process in place to quickly bring these issues to the attention of the board?
- What organizational, management, industry, or regulatory issues should the audit committee and the overall board be on the lookout for when evaluating potential risk?
- What actions does the audit committee take to help monitor the tone at the top and confirm its appropriateness?

Tax considerations for audit committees

The global legislative environment for tax issues continues to be uncertain as governments question whether jurisdictions are getting their fair share of revenue. Audit committees can benefit from staying up to date on recent developments and asking tax executives about their plans to address potential issues and risks.

Base erosion and profit shifting

Media, politicians, and the public have been questioning corporate structures that result in multinational organizations reporting profits in low-tax countries. In September 2014, the Organisation for Economic Co-operation and Development (OECD) released deliverables on seven of the 15 actions identified in the 2013 *Action Plan on Base Erosion and Profit Shifting* (BEPS). At its highest level, BEPS generally concerns the proper allocation of profits to lower-tax jurisdictions and the deduction of expenses in jurisdictions with higher rates.

Chief tax executives should understand the actions identified by the OECD and prepare for potential implications, including:

- Challenges to cross-border transfer pricing related to cross-border sales, services, and royalties
- Denial of deduction for cross-border interest expense in tax-benefited financing structures
- Disclosure of income allocated among the different countries in which a multinational corporation operates
- Additional scrutiny regarding the substantive business operations conducted in low-tax jurisdictions.

Inversions

On the U.S. legislative front, the potential for legislation affecting inversions is of high importance to many companies with global structures. An inversion may be executed in many types of transactions, the most prevalent being when a U.S. company combines with a foreign company and the new entity establishes its legal residency in a non-U.S. jurisdiction. This generally occurs in connection with a strategic merger or acquisition, and the related structuring may reduce the company's effective tax rate over time and improve the efficient deployment of cash in the global enterprise. Tax executives planning for transactions that result in inversions should consider:

- The tax implications for shareholders, as well as the corporate impact of the transaction; recent regulatory action has in some circumstances restricted the associated tax and treasury benefits
- Changes in operations, governance, and regulatory requirements, as well as the reaction of the public and customers
- More administrative and legislative actions being directed to limit the tax benefits from inversion transactions.

Financial statement accounting for taxes

Income tax issues continue to contribute to financial statement restatements, ranking as the fourth leading cause in 2013[3]. It is important for tax departments to have appropriately trained resources and internal controls to work through the complexities related to financial statement accounting and reporting for taxes. Valuation allowances, indefinite reinvestment assertions, and unrecognized tax benefits are among the areas that are closely scrutinized. As resources become constrained, it is important to consider controls and process and technology efficiencies that may reduce the time investment of tax personnel, leaving them more availability to consider complex issues.

3 Audit Analytics – *Financial Restatements 2013 – A 13-Year Comparison.*

Additional resources

United States Tax Alert: Treasury Anti-inversion Notice

United States Tax Alert: Schumer Anti-inversion Bill

United States Tax Alert: OECD Releases the BEPS Project 2014 Deliverables

Accounting for Income Taxes Quarterly Hot Topics, September 2014

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Questions for the audit committee to consider:

- What degree of coordination is there between the tax and accounting departments?
- How does the tax department stay current on tax laws, regulations, and leading practices? What current or upcoming developments could significantly affect the company's effective tax rate?
- What are the company's most significant risks related to tax positions, and what internal controls are in place to address those risks?
- What is the appropriate resource commitment for the tax function? How do tax data needs differ from the rest of the organization?
- What elements of the corporate structure are tax-driven? What should be presented to the board regarding tax?

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