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# Audit Committee *Brief*

## Top issues for audit committees in 2014

The demands on audit committees are expanding. At the same time, their primary responsibility to oversee management's activities, including financial reporting and compliance, remains fundamental to corporate governance. It can be challenging for audit committees to focus on their traditional core duties while staying up to date on emerging issues such as cybersecurity, proposed regulatory changes, and international developments.

Insights from the Audit Committee Symposium

To help committee members prioritize these issues, Deloitte recently held its 2013 Audit Committee Symposium, *Focus on Effectiveness*; insights from the event are included throughout this issue of the brief. Senior governance leaders and regulatory specialists, including former SEC Chairman Mary Schapiro, offered their perspectives on topics such as the evolving role of the audit committee, fraud risk, fiscal responsibility, investor issues, and regulatory developments. One common theme at the conference was the importance of staying informed, challenging information, and asking the right questions.

Greg Weaver, chief executive officer, Deloitte & Touche LLP, said, "The best audit committees have members with a broad set of knowledge and experience. I like to see committee members have an inquiring mind, challenge information, and be professionally skeptical."

Insights from the Audit Committee Symposium

"It is a best practice to have a three-legged stool arrangement, with the auditor, management, and the audit committee all receiving feedback on areas where they can improve. We all have tremendously important and valuable roles to play, and we ought to be holding each other accountable and continuing to elevate our performance."

**Joe Ucuzoglu**
National Managing Partner, Regulatory and Professional Matters, Deloitte LLP

This edition of the *Audit Committee Brief* highlights several issues audit committees may wish to focus on in 2014 to enhance their effectiveness. It provides an overview of developments and resources, along with additional points for audit committees to consider in addressing these topics and determining agenda items.



*Additional resources*

June 10, 2013, *Heads Up*: COSO Enhances Its Internal Control — Integrated Framework

The COSO Framework on Internal Control: Prepare for the Changes

## Updated COSO framework

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) recently released an updated version of its *Internal Control — Integrated Framework*. The 2013 update will soon supersede the original framework, issued in 1992, which has become one of the most widely adopted approaches to internal control. While the fundamentals of the new framework are similar to the original, the update:

- Outlines a formal structure for designing and evaluating the effectiveness of internal control
- Offers an expanded discussion of each component and principle, including detailed points of focus
- Explicitly calls for considering fraud risk when assessing risks to achieving organizational objectives.

The transition period for implementation extends through December 15, 2014. COSO has provided some transition specifics and is encouraging users to transition applications and related documentation as soon as possible. COSO will make its original framework available until the end of the transition period. While the framework is relevant for operations, regulatory compliance, and reporting, it is most widely used by companies to evaluate their internal control over financial reporting. Companies that provide their annual ICFR assessment in accordance with Sarbanes-Oxley Section 404 during the transition period should disclose which COSO framework was used in performing the assessment.

### Questions for audit committees to consider:

- Is the company using the framework for internal control over financial reporting only, or for operations and regulatory compliance as well?
- Have company controls been mapped to the new framework?
- Has the new framework revealed any gaps in current processes, control activities, or documentation, and if so, how are these being addressed?
- Is the company educating leadership, risk management, and control owners regarding the content in the updated COSO framework?
- What policies are in place and who is responsible for communicating internal control considerations to external parties (e.g., third-party service providers)?
- Does the company use information technology and data analytics to help continuously monitor internal control systems?

Insights from the Audit Committee Symposium

Former SEC Chairman Mary Schapiro, who now chairs the governance and markets practice at Promontory Financial Group, appeared at Deloitte's Audit Committee Symposium and highlighted the critical role internal audit plays in mitigating risk: "The audit committee can't be the eyes and ears throughout the entire organization, but internal audit can, so ensuring that internal audit has stature and resources within the organization is, I think, a critical responsibility of the audit committee."

*Additional resources*


[August 2013 *Audit Committee Brief*: Cybersecurity and the Audit Committee]


[Signals for Strategists: Cyber Crime Fighting]


[Insights on security and privacy in Deloitte's *CIO Journal*]


[Deloitte Diligence (a new tool to combat fraud and corruption)]

## Cybersecurity

In an increasingly digital world, it is highly challenging for companies to effectively defend their information technology systems, and the incidence of cyber attacks continues to rise rapidly. Cybersecurity is often at the top of agendas for audit committees and management at companies of all sizes and industries, since the pervasiveness of cyber issues connects them to financial concerns and internal controls. The changing technological environment can lead to sophisticated attacks that are difficult to anticipate and defend against if appropriate safeguards and response plans are not in place.

There are numerous categories of cyber attacks and a variety of corresponding motivations, including financial fraud, information theft or misuse, activist causes, and efforts to disrupt the critical infrastructure of government and its vital services. The perpetrators can range from individuals or small-scale operations such as insiders, suppliers, and activists to large-scale, organized efforts perpetrated by criminal networks and foreign governments. Common modes of attack include malicious software such as trojans, worms, viruses, and spyware; password phishing; and denial-of-service attacks to crash websites.

The audit committee plays a vital role in monitoring management's preparation for and response to cyber threats.

### Questions for audit committees to consider:

- What are the organization's critical assets to be secured, and how are vulnerabilities identified? How are risks disclosed?
- How are critical infrastructure and regulatory requirements met?
- What is the overall strategy and plan for protecting assets from cyber attacks?
- How robust are the organization's incident response and communications plans?

## Proposed auditor's reporting model

The PCAOB recently proposed auditing standards on the auditor's reporting model and the auditor's responsibility for other information in annual SEC filings. These standards, proposed in August 2013, could significantly change the external auditor's report and necessitate expanded audit procedures.

While retaining the "pass/fail" audit report, the PCAOB's proposal would represent the most significant expansion of information required from auditors in the profession's history. The proposed revisions are in response to concerns expressed by U.S. and global constituents, including investor groups, that the auditor's report contains little or no information specific to a particular audit.

The proposed auditing standards are intended to increase the value, usefulness, and relevance of the auditor's report; expand the auditor's responsibilities for information outside the financial statements; and include specific reporting in the auditor's report. The significant proposed changes include:

- A new section in the auditor's report on critical audit matters specific to the audit:
  - Critical audit matters are defined as those matters the auditor addressed during the audit of the financial statements that (1) involved the most difficult, subjective, or complex auditor judgments; (2) posed the most difficulty to the auditor in obtaining sufficient appropriate audit evidence; or (3) posed the most difficulty to the auditor in forming an opinion on the financial statements
  - The PCAOB's proposal could potentially change the long-standing reporting model of management being responsible for the company's financial statements and disclosures and the auditor attesting to that information; some of the illustrative examples of reporting on critical audit matters provided in the proposal disclose what appears to be original information about the company that is not otherwise disclosed by management
- Enhanced language in the auditor's report on auditor responsibilities
- New statements in the auditor's report providing more information on areas such as auditor independence and tenure
- Increased auditor responsibility for other information in the company's annual report (including information incorporated by reference), and disclosure about this responsibility in the auditor's report.

*Additional resources*


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[September 5, 2013, *Heads Up*: PCAOB Proposes Changes to the Auditor's Reporting Model and the Auditor's Responsibilities Regarding Other Information]


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Audit Committee Brief

[June/July 2013 *Audit Committee Brief*: A Voice at the Table: Becoming More Involved in the Financial Reporting Regulatory Process]

Insights from the Audit Committee Symposium

Speaking on the topic at Deloitte's 2013 Audit Committee Symposium, Joe Ucuzoglu, national managing partner, regulatory and professional matters, Deloitte LLP, said, "There is a demand from users and investors to hear more from the auditors. A common observation from investors is, 'We are the ultimate customer. The auditors need to say more; they have valuable things to say.'" He went on to say, "There is the perception that some incremental level of transparency would be helpful through generating additional confidence in the audit process and providing more useful information to investors."

The proposal containing the proposed standards and related conforming amendments indicates the effective date would be for audits of financial statements for fiscal years beginning on or after December 15, 2015; however, this date will depend on the nature and extent of revisions the PCAOB determines are necessary based on comments and other input on the proposal, as well as approval by the PCAOB and SEC of any final standards and related conforming amendments and the associated timing.

**Comment period still open**
Given the significance of the proposed changes to the auditor's reporting model, audit committees may wish to consider providing feedback to the PCAOB; the proposal is open for public comment through December 11, 2013. Appendices 5, 6, and 7 of the release contain questions that apply to various sections of the proposed standards. The PCAOB is also considering holding a public roundtable in 2014 to discuss the proposed standards and comments received. Deloitte's June/July 2013 *Audit Committee Brief* provides information on how to participate in the PCAOB's standard-setting process.

## PCAOB Auditing Standard No. 16, *Communications with Audit Committees*

PCAOB Auditing Standard No. 16 (AS 16), *Communications with Audit Committees*, is effective for audits and quarterly reviews of fiscal years beginning on or after December 15, 2012. The PCAOB's primary objectives in issuing AS 16 are to (1) enhance communications between auditors and audit committees and (2) improve audits by fostering constructive dialogue between the auditor and the audit committee. The audit committee should keep the following auditor's responsibilities in mind with respect to year-end communications.

| AS 16 requirement | New or expanded | Timing |
|---|---|---|
| Communicate significant changes to planned audit strategy or the significant risks identified and the reasons for such changes | New | As needed at interim or year-end |
| Communicate information about audit results, including:<br>• Significant and critical accounting policies and practices<br>• Critical accounting estimates<br>• Significant unusual transactions | Expanded | Primarily at year-end; quarterly communications generally only required for significant changes |
| Communicate the following:<br>• Qualitative aspects of significant accounting policies and practices<br>• Assessment of critical accounting policies and practices<br>• Conclusions regarding critical accounting estimates<br>• Understanding of business rationale for significant unusual transactions<br>• Evaluation of financial statement presentation<br>• Any concerns related to management's application of new accounting pronouncements<br>• Alternative accounting treatments discussed with management | Expanded | Primarily at year-end; quarterly communications are required for significant changes and matters relevant to the interim financial statements |

### *Additional resources*


[September 18, 2012, *Heads Up:* PCAOB Approves Auditing Standard on Communications with Audit Committees]


[Audit Committee Resource Guide]

## Foreign Corrupt Practices Act

Foreign Corrupt Practices Act (FCPA) enforcement actions have recently been increasing, and will likely continue to be a hot topic in 2014. Corruption-related issues can arise from and potentially involve all parts of an organization, from employees to affiliates to suppliers and other third-party intermediaries. Organizations and individuals found to have violated the FCPA may be subject to a variety of consequences, including significant fines, reputational damage, weakened stock price, loss of business, and costly litigation.

Companies with strong anti-corruption compliance programs will likely be better positioned to prevent and detect potential violations, and to reduce or even avoid criminal and civil liability should a violation occur. Audit committees are often directly involved in assessing whether management has developed and is maintaining an effective compliance program to address corruption risk. Each board member should understand the components of an effective anti-corruption compliance program in order to assess its adequacy. An effectively designed, implemented, and managed compliance program tailored to a company's specific risks is paramount. The audit committee should consider assessing important components such as:

- The overall compliance structure
- The thoroughness of the anti-corruption risk assessment
- Policies and procedures covering riskier activities
- Training protocols
- Protocols for third-party and distributor due diligence
- The substance and frequency of senior management and regional compliance officer anti-corruption communications
- The whistleblower reporting systems for employees and third parties
- Monitoring and audit processes
- Disciplinary and incentive procedures for violations of anti-corruption policies and procedures
- Anti-corruption merger and acquisition due diligence procedures.

### Questions for audit committees to consider:

- Are we conducting periodic anti-corruption risk assessments to continuously evaluate and manage our corruption risk profile?
- How does management communicate its continued commitment to compliance (i.e., the "tone at the top")?
- Can we provide evidence that our compliance program is well designed, effectively overseen, and tailored to our size, structure, and risk profile?
- Do we provide country-by-country FCPA reinforcement training tailored to geography- and business-specific risks?
- Are we doing enough anti-corruption due diligence during pre-acquisition and post-acquisition integration?

### *Additional resources*


October 2013 *Audit Committee Brief:* Navigating Anti-Corruption Compliance


New FCPA Resource Guide: Ten Things for Legal and Compliance Officers to Consider


Guarding against Fraud and Corruption: The Audit Committee's Role

## Tax reform and regulatory authority spotlight

Tax reform is expected to remain a priority in Congress for at least the next year as lawmakers struggle to agree on fundamental questions such as whether a tax code overhaul should be revenue-neutral or raise revenue for deficit reduction, and which corporate tax expenditures should be modified or eliminated to pay for a lower corporate tax rate. That ongoing debate, together with the inevitable transition issues that will arise as proposals move through the legislative process and are enacted into law, means that tax reform will likely be an important boardroom topic over the next several years. Organizations will look to their chief tax executives to advise them on the effect of tax reform proposals.

In addition, base erosion and profit shifting (BEPS) continues to be a focus of the Organisation for Economic Co-operation and Development (OECD). At its highest level, BEPS generally concerns the movement of profits to where they are taxed at lower rates, and the movement of expenses to where they are relieved at higher rates. A key point of focus is situations where the interaction of different jurisdictional tax principles results in a mismatch and the potential non-taxation of profits. The OECD recently published an action plan on addressing BEPS and identified 15 areas for further work, including a summary of key considerations to be addressed and the timetable for work in each area. Chief tax executives should understand the actions identified by the OECD, prepare for the possibility of rapid legislative changes, and consider current and proposed business plans in light of possible changes.

In addition to the changes that may result from tax reform and OECD responses to BEPS, tax executives should continue to focus on the complexity of the tax code and financial reporting for income taxes. This continues to be a challenge as companies struggle to find competent resources; tax matters have recently been a leading cause of material weakness and restatements. Because the judgment required to appropriately address complex tax issues is significant and evolving, audit committees should consider tax processes and controls in their discussions and financial reporting oversight.

Regulatory authorities also continue to emphasize the importance of greater transparency in financial statement reporting, with a focus on income tax accounting and reporting. The SEC has increased scrutiny in areas such as the tax accounting for investments in foreign entities, including the indefinite reinvestment of foreign earnings, due to the significant judgment involved.

### Questions for audit committees to consider:

- How does the tax department stay current on tax laws, regulations, and leading practices? How is the department assessing the potential effect of tax reform and OECD actions?
- What are the company's most significant risks related to tax positions, and what internal controls are in place to address those risks?
- What judgments are involved in the company's tax planning strategies and transfer pricing policies? What does the company rely on to support those positions?
- What key judgments are made in connection with assertions regarding the indefinite reinvestment of foreign earnings? What documentation does the company maintain to support those assertions?
- Do recent regulatory audits and actions raise concerns about how the tax function operates and evaluates the recognition and measurement of tax positions?

*Additional resources*

Deloitte Dbriefs: Base Erosion and Profit Shifting

*Accounting for Income Taxes Quarterly Hot Topics*: June 2013 Issue

## Risk oversight

Risk oversight has taken on increased importance for boards and audit committees. Many boards are evaluating their risk governance structure and which committees have the skills and knowledge to oversee particular risks. The SEC considers risk oversight a key responsibility of the board and requires this role to be disclosed to improve investors' understanding of board activities.

Insights from the Audit Committee Symposium

During Deloitte's Audit Committee Symposium, Michael Young, litigation partner at Willkie Farr & Gallagher LLP, spoke about fraud risk and the role of the audit committee. Noting that financial fraud typically starts with the pressure to achieve specific results, Young said that audit committees should have a "system of sustained interaction with strategically placed people." He recommended considering where there are financial reporting vulnerabilities and who is closest to them, and advised committee members to ask management, internal audit, external audit, and others in the organization, "Where are you feeling a little discomfort?"

Audit committees are responsible for overseeing the process for identifying and addressing financial risks. The NYSE listing standards require the audit committee to discuss the company's risk assessment and risk management policies with management. Although it is the responsibility of senior management to assess and manage the company's risks, the audit committee should focus on areas of major financial risk and discuss the guidelines and policies for addressing them. Financial risks often arise from other sources of risk, such as strategy, operations, and compliance with environmental, health, safety, legal, and regulatory requirements. Therefore, audit committees may want to consider widening the lens and adopting a more proactive approach to avoid reactive situations.

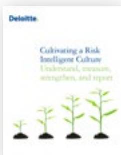
Insights from the Audit Committee Symposium

At Deloitte's Audit Committee Symposium, Kurt Schacht, managing director of the CFA Institute, said, "There is an increasing and evolving expectation on the part of investors for the audit committee to have a bigger role in things other than just audit or financial reporting issues, and more into the realm of risk issues."

Consequently, risk oversight is often high on the list of agenda items for audit committee meetings. Greg Weaver, chief executive officer, Deloitte & Touche LLP, emphasized the importance of requiring clear communication: "The audit committee sets the tone for the meeting, and should make it clear that if there's something the committee needs to know, it's the responsibility of attendees to provide that information directly and concisely."

*Additional resources*

[Exploring Strategic Risk: 300 Executives around the World Say Their View of Strategic Risk Is Changing]



[Cultivating a Risk Intelligent Culture: Understand, Measure, Strengthen, and Report]

## Leading practices

- Increase the focus on risk oversight and assessment.
- Avoid becoming overly dependent on forms or tools for monitoring risk.
- Periodically reassess the list of top risks, determining who in management and which board committee is responsible for each.
- Evaluate IT projects, including milestones and reporting, especially for IT transformations.
- Consider post-acquisition reviews, including risks, relevant integration milestones, and return-on-investment analyses, to evaluate the reliability of initial acquisition assumptions.
- Have the appropriate business leaders make a presentation at a board or audit committee meeting to enhance committee members' understanding of the business and risks and to evaluate the depth of talent.

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