The Job of the Audit Committee: Getting Directors on the Same Page

FEI's former CEO, who chairs two audit committees, outlines a framework for determining the panel's responsibilities and carrying them out.

By Philip Livingston

Continuous improvement has been the rallying cry for audit committees since the 1999 Blue Ribbon Panel on audit committee effectiveness. Since that time, Congress has weighed in on the subject, the New York Stock Exchange (NYSE) and Nasdaq have issued vastly expanded audit committee requirements, the National Association of Corporate Directors has published its own audit committee guide and countless conferences and symposiums have occurred.

In the field, audit committee skepticism is up, meetings are longer and the agenda items are considered more intently. Yet, there is still a need for more director education and dialogue. Most companies need a better understanding between the directors, management team and the auditor as to the mission and workflow of the audit committee. Like a championship sports team, the objective must be clear and the communications have to be frequent.

What's the overall purpose of the audit committee? It's not to oversee everything related to finance, and it's definitely not to drive down the auditor's fee — probably the most common unstated agenda prior to the recent reforms. The purpose and authority of the committee comes from the board in the form of the committee charter. The board delegates certain functions to its committees, and the audit committee's key responsibilities are to:

- Oversee the company's financial reporting to its stakeholders
- Promote an effective independent audit of the financial statements
- Oversee the system of internal control
- Monitor the process of risk identification and management

Let's talk about each of these points and bring them into practical focus.

1) **Financial Reporting** — Overseeing financial reporting is really about

cutting through the complexity of accounting and making sure that the enterprise's performance is clearly communicated. Are the statements readable and useful? Many investors today focus on the management discussion and analysis. They expect, and should get, a good summary of the same important business trends and concerns that come out in boardroom discussions.

Inherently, financial statements require many judgments, accounting principle choices and valuation estimates. The committee should be made aware of the choices that management has made in compiling the financial reports. Aggressive application of accounting principles should be discouraged, and the use of reasonable estimates encouraged. A recent and valuable requirement of the financial statements is a critical accounting policies summary where the most important estimates and judgments should be listed, with some quantification of each matter's impact.

2) **Effective audits** — An audit committee doesn't audit! It's not a standing investigative panel, either. It should be empowered to conduct investigations within its scope of responsibilities and to get the resources it needs. However, if a major problem does arise, the board will probably set up a "special committee" to oversee the review.

But a major function of the audit committee is to promote an effective independent audit. Most of this work is about observing and assessing the auditor. How competent are the top personnel on the audit engagement? Do they seem to understand the company's business? Can they clearly explain where they see risk both in the business and the financial statements? How have they satisfied you that their audit addresses the risks?

The committee's value and impact is significant in setting the tone for the auditor's work. It can emphasize that management must be candid with the auditor. The auditor should know that the committee wants clear and correct financial statements above all else. The committee can query the auditor to be sure they are hearing about the same business risks and issues that arise in the board meetings.

An valuable approach is to illuminate issues and provide a positive and safe workout situation for problems for both management and the auditor. Doing business is tough, and problems are constant; significant value comes from just recognizing these facts and encouraging everyone to not sweep issues under the carpet for fear of repercussions.

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Lastly, and most importantly, the auditor must know that in design and in practice, only the board can dismiss the auditor. This must be emphasized to the management team as well. An auditor can't conduct an independent audit if the threat of reprisal exists from the company's management team. Beyond hiring and dismissal, "auditor independence" is an expansive topic in itself with a growing body of restrictions and requirements. Values of safety, clarity, candor and "get it right" should be inherent in the audit and the financial statement process.

3) **Internal Control** — Oversight of internal control is a large subject made only more complicated by the implementation of Sarbanes-Oxley Section 404. Much has been written on that specific requirement and is widely available for directors to educate themselves.

In general, an audit committee's concerns about internal controls should center on understanding the fundamentals. Does the company have formal and written policies and procedures for handling and approving routine and non-routine transactions? Are there written accounting policies? Are there adequate resources in the finance function? What is the background and competency of the finance and accounting personnel? NYSE companies are required to have an internal audit function. How effective is internal audit in detecting control failures?

4) **Risk Management** — The audit committee's role in risk management is significant. In many companies, the only time that a formal risk assessment is done is annually under the auspices of internal audit and the committee's initiatives. Formal interviews or surveys of all board members and senior management are typically summarized, often with surprisingly candid and common responses. Such a process feeds the external and internal auditors planning, as well as providing a framework for the acquisition of formal insurance products.

Risk assessment often generates significant management succession issues that are rightly referred to the board's compensation or human resources committees. Overall, it's a healthy process that heightens the sensitivity to pitfalls of the company's business and industry.

In conclusion, an effective audit committee is one focused on its purpose, as assigned to it by the board of directors and, ultimately, the shareholders. A good framework of understanding between the directors, management and the auditors about financial reporting, the independent audit, internal control and risk management is the clearest and most direct way to align the committee's work with that purpose.

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