PUBLISHED BY THE INSTITUTE OF INTERNAL AUDITORS

TONE at the TOP

Issue 52 September 2011

EXCLUSIVELY FOR SENIOR MANAGEMENT, BOARDS OF DIRECTORS, AND AUDIT COMMITTEES

Taking the Job Seriously

Accountability. Responsibility. Diligence. These are just a few among many essential concepts inherent in the very serious role of audit committees. Having effective members of this all-important oversight body is a sometimes daunting challenge that could mean the difference between an organization's success and failure.

What critical roles do audit committees play in today's business arena and why are exemplary members in such high demand? For optimal effectiveness, an audit committee should:

- Be certain that management is highly responsive to the expectations of shareholders, regulators, legislators, and all other stakeholders.
- Provide oversight to ensure accuracy and appropriate transparency in regard to financial disclosure, while thoroughly understanding, evaluating, and monitoring all key aspects of financial reporting.
- Ensure the proper focus is placed on internal control to help mitigate risks associated with financial reporting, compliance, and fraud.
- Help establish the appropriateness of the tone at the top and ensure management is emulating the correct tone throughout the organization.
- Oversee the effectiveness and competency of both internal and external auditors.
- Have a clear understanding of the critical role the full board is delegating to it as a committee, and ensure the committee chair is reporting key matters to the board as warranted.

In this issue of *Tone at the Top*, we will examine some of the most important aspects of audit committee effectiveness, as reported in *Audit Committee Effectiveness — What Works Best, 4th Edition*, an important research study recently authored by PricewaterhouseCoopers (PwC) US and published by The Institute of Internal Auditors Research Foundation.

OVERSEEING FINANCIAL REPORTING

Although an audit committee may take on many responsibilities, its central job is to oversee the integrity of the company's financial statements and related disclosures. Effective audit committees bring the appropriate level of skepticism to this oversight by asking probing questions and having frank discussions with management and the auditors. Areas that have the greatest potential risk for negative effects on internal control over financial reporting include management override of controls, outside service providers, IT, mergers and acquisitions, and restructuring. Also, the risk of financial reporting fraud must not be ignored.

Beyond the oversight of the organization's numerous accounting and financial management activities, audit committees are bound to open transparency with stakeholders. At minimum, regulated disclosures and all information important to investors and other stakeholders must be communicated comprehensively. Effective audit committees must also stay current on all regulatory agency inquiries and the company's responses, as well as be aware of anything that might require management to change or restate previously released earnings. Having a big-picture perspective of the overall financial performance of the organization helps audit committees effectively monitor forward-looking guidance by investors, analysts, lenders, and securities regulators — which ultimately affects the company's market performance.

"People expect more from audit committees today," said Catherine Bromilow, partner in PwC's Center for Board Governance and co-author of *Audit Committee Effectiveness — What Works Best.* "Following the economic crisis that started in 2008, the audit committee's role in ensuring accurate and transparent disclosure is more difficult and challenging than ever."

OVERSEEING RISK MANAGEMENT

Companies face numerous risks, including strategic, operational, and environmental risks. It's important for audit committees to understand the extent of their risk oversight responsibilities, and they should stay focused on the organization's most complex areas with the greatest risk by reviewing and analyzing associated business issues, accounting policies, and other relevant information. There should be an in-depth understanding of the business and its structure, operations, marketing, competition, standing, and reputation. An enterprise's risk picture includes strategic, financial, operational, compliance, reputation, technology, and fraud risks. An effective audit committee must ensure management has assessed, prioritized, monitored, and controlled these risks as much as possible.

Audit committees should take primary responsibility for overseeing how management monitors and controls the company's major risks, including periodically meeting with the individuals who identify and manage such risks. Although the audit committee should be vigilant, it is important that it does not become overburdened by taking on the responsibility to oversee more risks than it can handle. Therefore, it is essential that the audit committee work with other board committees to ensure oversight responsibility is allocated appropriately.

To ensure optimal audit committee performance and effectiveness, members should obtain comprehensive information on key questions, including:

- How does management identify events that could put the company at risk, and how does it assess the likelihood and impact of those risks?
- How should the audit committee put into place a process for working with other board committees to ensure that all key risks are subject to board-level oversight?
- What are the top risks management has identified, and have they been communicated fully to the entire board?
- How has management tailored the risk management process to meet the company's specific needs?
- Does the individual with primary responsibility for risk management have appropriate expertise, stature within the company, and the time required to adequately fulfill that responsibility?
- What is internal auditing's role in risk management, and to what extent does the audit plan cover the key risks?

Clearly, all companies do not have the same tolerance for risk. In other words, one size does not fit all. For optimal effectiveness, any risk management program should be tailored to meet the risk appetite of the organization. A broad range of risk management and oversight practices have proved effective over time. Those at the top — both executive management and the audit committee — are wise to explore best risk management practices to determine what approaches might be most appropriate for, and applicable to, their specific organization.

OVERSEEING INTERNAL AUDITING

A highly competent internal audit department can be an important resource to help the audit committee understand how well the company is managing its business risks. But it's imperative that internal auditing's full value proposition is realized and embraced, thus assisting the audit committee in fulfilling its governance role effectively. Once the committee understands the work internal auditing is performing, what it's capable of doing, and management's objectives for internal auditing, it can reach consensus on internal auditing's role in providing maximum value. The audit committee's challenge is to be comfortable that internal auditing is focusing its efforts in the right places and using its resources to provide not only value to management, but also assurance to the audit committee.

Of course, internal auditing's resources are not limitless. To ensure the organization's most pressing risks are mitigated, effective audit committees review the planned scope of internal audit activities and understand how it responds to the levels

INSIGHTS

The following are comments from audit committee chairs regarding their role in understanding their organization's business and finances:

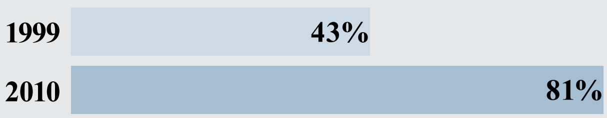
"Listening to replays of analysts' calls is a great way to determine how the outside world views our company."

"Having a profound knowledge of the business is a key element of ensuring our financial reports properly portray the company."

Source: *Audit Committee Effectiveness — What Works Best, 4th Edition*

REPORTING LINES

The IIA's 1999 GAIN survey showed 43 percent of internal audit directors reported directly to the audit committee chair. Compare that to the 2010 survey, which shows 81 percent of internal audit directors report directly to the audit committee chair. Such a dramatic shift in only a decade demonstrates the understanding of how important it is for internal auditing to be able to report issues to a supervisory body, not just to management.



IA Directors Reporting Directly to Audit Committee Chair

Source: *IIA Global Audit Information Network (GAIN)*

and types of risks within the organization. Astute audit committees recognize that internal auditing needs flexibility to respond to significant changes in the company. As companies mature in other risk and compliance activities, it is appropriate for the audit committee to ask how internal auditing leverages assurance provided by the company's other risk or compliance functions.

So, what roles do internal audit functions typically fulfill? Internal auditing's role should be reflected in its charter, which sets out its purpose, authority, reporting structure, responsibilities, and objectivity. The internal audit reporting level is also important. It should demonstrate the highest support for internal auditing's mandate, and it should support the function's objectivity. Along with its administrative reporting line to management — typically the CEO or chief financial officer (CFO) — it is appropriate for internal auditing to have a direct reporting relationship to the audit committee.

The audit committee can rely on internal auditing's work and findings only if the function fulfills its duties. So, it's important the committee periodically discusses the internal audit department's effectiveness. It should understand the way the internal audit function monitors is own quality. The IIA's *International Standards for the Professional Practice of Internal Auditing (Standards)* require internal audit functions to have an external quality assurance review every five years. Effective audit committees seek input from stakeholders such as the CFO and other members of management to determine how internal auditing is perceived throughout the organization and whether it approaches its work with a client service mentality.

THE TONE AT THE TOP

Although tone at the top oversight is the responsibility of the entire board of directors, an effective audit committee plays a key role in ensuring it is positive and healthy, and that what you see is what you get. Discussing with human resources feedback from the organization is one way the audit committee can determine whether the appropriate tone and company values are exemplified throughout the entire enterprise. In addition, monitoring employee complaints and the whistleblower hotline provides a good perspective of the organization's ethical culture.

INSIGHTS

The following are comments from audit committee chairs regarding the importance of an organization's tone at the top:

"Tone at the top is easy to judge if it's at the extremes — either very good or very bad. It's tougher when the tone is somewhere in the middle."

"From a practical perspective, assessing the tone at the top is difficult as a stand-alone exercise. We very much base it on a holistic assessment of numerous factors (e.g., formal and information meetings, reviews of reports, watching management's actions)."

Source: *Audit Committee Effectiveness — What Works Best, 4th Edition*

TIME FOR SERIOUS WORK

Without a doubt, serving on the audit committee requires a substantial commitment and demands a significant amount of time. Effective audit committee members cannot be too dedicated, too diligent, too proactive, or too conscientious. They must insist on the highest standards for their organizations. And, in order to be the best they can be on behalf of all stakeholders, they must take the time required to learn everything they need to know. Serving on the audit committee is, indeed, work that must be taken very seriously.

Audit Committee Effectiveness — What Works Best is published by The IIA Research Foundation and authored by Catherine L. Bromilow, CPA and Donald P. Keller, CPA, both partners in PwC's Center for Board Governance. For more information, visit www.theiia.org/bookstore.

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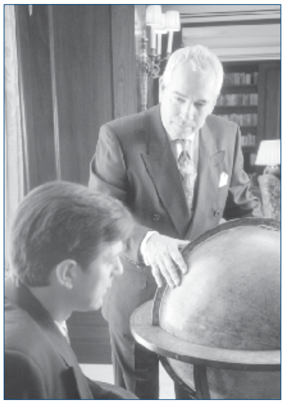

Mission

To provide executive management, boards of directors, and audit committees with concise, leading-edge information on such issues as ethics, internal control, governance, and the changing role of internal auditing; and guidance relative to their roles in, and responsibilities for, the internal audit activity.

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The IIA is the global voice, recognized authority, chief advocate, principal educator, and acknowledged leader in certification, research, and technological guidance for the internal audit profession worldwide. The IIA enhances the professionalism of internal auditors and is internationally recognized as a trustworthy guidance-setting body. It fosters professional development, certifies qualified audit professionals, provides benchmarking, and through The IIA Research Foundation, conducts research projects and produces educational products.

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