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Audit Committee Disclosure: More Hints

By Tammy Whitehouse

Regulators are preparing to draft new disclosure rules for audit committees, and some say the move could ignite a new debate about whether that should include disclosing the names of audit engagement partners.

The Securities and Exchange Commission is expected to issue a concept release “soon,” Brian Croteau, deputy chief accountant, said at a recent regional conference of the Institute of Management Accountants. The release will explore several areas where audit committees could have more to say to investors about their selection and oversight of external auditors. And SEC Chairman Mary Jo White, addressing a meeting in 2014 of an advisory group to the Public Company Accounting Oversight Board, said the concept release will consider the relationship between audit committees and independent auditors.

The PCAOB, meanwhile, has given itself until October 2015 to issue the next iteration of its rulemaking effort to give investors more information about the identity of the engagement partner and other participants in the audit beyond those employed by the principal audit firm. Dating back to 2009, the PCAOB began proposing that engagement partners sign the audit report, much the way CEOs and CFOs certify financial statements. Facing heavy resistance over concerns about increased liability, the board moved instead to require the name of the engagement partner in the audit report—which still didn’t satisfy those who perceived a heightened liability for auditors.

Even current members of the five-person PCAOB board have criticized the idea, leading board members to hint they are working on yet another idea: to require disclosure of the engagement partner in a separate form or filing with the PCAOB. During the long-running debate, some commenters have said the SEC should require the disclosure of the engagement partner through the audit committee, rather than requiring audit firms to provide that detail to the PCAOB.

“It’s an interesting question,” Croteau says, and it might prompt the SEC to solicit comments on audit committee disclosure ideas at the same time as the PCAOB is asking for ideas about audit firms. No dates have been set for either release, Croteau says, “but our staff and PCAOB staff have already been working on it, and I am hopeful both releases will be out for comment soon.”

Audit committee disclosure requirements have not changed since before the Sarbanes-Oxley Act of 2002, says Thomas White, partner at law firm WilmerHale. “There are a bunch of different rules that require different disclosures that appear in different places,” he says. “It hasn’t been fixed for a while now.”

White describes the currently required disclosures as “somewhat limited,” focused on identifying the qualifications and independence of audit committee members, communication of the audit committee with the external auditors, and audit fees. “Given the emphasis on audit committees as part of a company’s governance structure and the important role it plays with respect to financial statements, compliance, and the appointment, oversight, and compensa-

tion of the auditor, many have thought some additional disclosures by audit committees would be appropriate,” he says.

Michael Scanlon, a partner at law firm Gibson Dunn & Crutcher, says over the past five years, and especially the last two years, a number of large companies have voluntarily reviewed and increased their audit committee disclosures. Some shareholder activism and an initiative by several prominent governance organizations to issue a “Call to Action” report has led many audit committees to raise their game, he says. “The audit committees of those large compa-

BETTER AC DISCLOSURES

Below is an excerpt from the “Call to Action: Enhancing the Audit Committee Report,” which provides examples of more transparent audit committee disclosures.

Importantly, we note a growing trend among a number of leading audit committees that are voluntarily addressing the need for enhanced audit committee reporting in order to strengthen confidence and communication. We give examples of their disclosure language, pulled directly from 2013 proxy statements, which demonstrate emerging practices in key areas. While not intending to be prescriptive or suggest a mandate, these leading disclosure examples provide benchmarks that other audit committees can use to evaluate the effectiveness of their own disclosures:

- » Clarify the scope of the audit committee’s duties
- » Clearly define the audit committee’s composition
- » Provide relevant information about:
 - Factors considered when selecting or reappointing an audit firm
 - Selection of the lead audit engagement partner
 - Factors considered when determining auditor compensation
 - How the committee oversees the external auditor
 - The evaluation of the external auditor

... we believe audit committees should critically evaluate their disclosures and carefully consider whether improvements can be made to provide investors with more relevant information that conveys that an informed, actively engaged and independent audit committee is carrying out its duties. If so, we encourage audit committees to begin taking the necessary steps with those charged with governance in their organizations to strengthen such disclosures accordingly. We recognize that some disclosures about audit committee-related activities may appear outside the audit committee report, elsewhere in the proxy statement, in the annual report, or on a company’s website. However, a complete understanding of the audit committee’s activities would require a close analysis of the information in each of these different places. For investors, navigating and mining for information across disparate sources is likely suboptimal. We encourage audit committees and boards to take a fresh look at the format and, in some cases, the different channels that communicate audit committee-related activities and strive to streamline, link to, or consolidate where possible.

Source: AuditCommitteeCollaboration.org.

nies have heard the calls for increased disclosure and have picked up and really enhanced their package of disclosures.”

The Call to Action report provided examples of more transparent audit committee disclosures and encouraged companies to follow suit in better explaining, for example, the scope of the audit committee’s duties, the make-up of the audit committee, the selection or re-appointment of the audit firm, the selection of the lead engagement partner, the factors that went into determining auditor compensation, and the oversight and evaluation of external auditors.

Cindy Fornelli, executive director of the Center for Audit Quality (one of the groups that collaborated on the report), said in a recent webcast that audit committees would be wise to step up their voluntary disclosures as a way to minimize the demand for new rules. “Demonstrate to lawmakers that additional requirements are not necessary so you don’t end up with a one-size-fits-all approach,” she said. “Voluntary disclosure allows companies to tailor the disclosures to fit their company.”

In Scanlon’s view, audit committees likely will not quarrel with a requirement to disclose many of the pieces of information that some audit committees have voluntarily provided in recent years. “If you look at the enhancements that many large companies have made over the past year or two, and if those play out as mandated or encourage disclosures in the SEC’s concept release, that will be a fine thing,” he says.

Audit committees are likely to have more concern, however, if the SEC’s concept release heads down a path of requiring disclosure of what the audit committee and external auditor have discussed during the course of the year, Scanlon warns. The resistance might be similar to that raised when the PCAOB first explored having auditors provide something akin to a “discussion and analysis” in audit reports explaining the difficult issues that arose in the audit.

In White’s view, requiring audit committees to name engagement partners would address a big obstacle: the continued insistence that naming engagement partners in the audit report would expose auditors to increased liability. “Putting it in the audit committee disclosure in the proxy statement is one way to deal with the problem,” he says.

Scanlon believes the identification of the engagement partner will continue to be the disclosure hot potato. “I would be surprised if the SEC’s concept release went down that path,” he says. “Identifying the engagement partner is a tricky issue for liability reasons.”

Mark Cheffers, chief executive officer at Audit Analytics, said during a webcast that Mary Jo White’s public remarks indicating the importance of high-functioning audit committees suggests that audit committees can expect more on their plates soon. “This to me foreshadows what I would consider to be increasing amounts of fiduciary and statutory obligations coming their way,” he said. “Audit committees are about to get more and more responsibility, and more and more exposure.” ■



Scanlon

AUDITOR & AUDIT COMMITTEE RELATIONSHIP

Below is an excerpt from the Investor Advisory Group about how audit committees currently operate.

Current State Observations

- » Audit Committees have fiduciary and statutory duties—yet their work is often not appreciated by, or transparent to, investors.
- » Audit Committees play a key role in controls over financial reporting—yet the report on their work does not appear with the audited financials.
- » Audit Committees may be made up of members who have far less training or experience than the individuals whom they oversee—yet they are expected to challenge these individuals.
- » Audit Committees spend most of their time on matters other than the annual audit—yet oversight of the audit is the only required responsibility reported to investors.

Multiple Regulators of Audit Committees

- » Sarbanes-Oxley Act – Covers Duties and Responsibilities
- » SEC – Covers Independence and Monitoring
- » Exchanges – Cover Governance Roles and Reporting
- » PCAOB – Covers Auditor Interactions

Current State Issues

- » Investors and regulators are seeking more discussion and analysis of the financial reporting and auditing process—but seem to be bypassing the Audit Committee for that information.
- » Governance advocates are calling for more discussion and transparency from the Audit Committee—NACD, CAQ and others have endorsed a “call for action.”
- » Regulators outside the United States are requiring more information from the Audit Committee—even asking for a shareholder vote on Audit Committee performance.
- » Regulators within the United States seem to be accepting the bypass instead of subjecting the work of the Audit Committee to greater transparency and oversight.

Potential Future State

- » Audit Committees could become a more transparent part of the disclosure framework—reporting on the processes they oversee within the same documents that contain the outcomes of those processes.
- » The Audit Committee report could be required to address specific interests of investors and regulators.
- » External auditors could be required to assess and report on the design (charter) and effectiveness (qualifications and activities) of the Audit Committee as a critical part of assessing an issuer’s controls over financial reporting and tone-at-the-top.
 - This is the dilemma in the current system—can auditors independently and objectively assess the effectiveness of the body that hires them?

Source: Investor Advisory Group.

What You Tell the Audit Committee About Auditors

CW polls audit executives on their relationship with the audit committee

By Matt Kelly

Compliance professionals under the age of 30 might not believe this, but once upon a time a company's audit committee was primarily responsible for—get this—the annual company audit.

Today, of course, the audit committee is also responsible for risk management, regulatory compliance, internal investigations, cyber-security, and pretty much anything else that goes wrong at a large organization. Yet we do have some fresh news on the audit committee's most primordial duty: selecting and overseeing the company's external audit firm.

Compliance Week has surveyed senior audit and compliance executives about what discussions you have with your audit committees about the external audit firm, and what information the audit committee wants to know about the audit firm before signing an engagement contract. We have more than 100 responses now, from a variety of large-cap and mid-cap companies.

So let's do a gap analysis of what compliance and audit executives want to know about their audit firms, what audit committees want to know, and what information you actually present to the committee—because, believe me, there are gaps.

First, the large majority of you (78 percent) do prepare and conduct reviews of your audit firm for the audit committee. Frankly, I'm more curious about the 22 percent who do not review the audit firm's performance, given how expensive the annual audit can be, but perhaps with a larger sample size that number might be lower. I hope so, and I suspect regulators like the Public Company Accounting Oversight Board would hope so too. The PCAOB has been calling for companies to pay more heed to their interactions with audit firms for a few years now.

Perhaps more interesting is that 60 percent of compliance and audit executives don't do any peer analysis of other companies and their audit firms when preparing to brief your audit committee, and 80 percent say the process to pull together data and prepare a report for the audit committee has seen only "slight" improvement or no improvement at all in the last 10 years.

Think about that for a moment. For all the tumult we've seen in the last decade—the rise of SOX compliance, steep increases in annual audit fees, PCAOB inspection reports that paint quite unflattering pictures of audit firms, huge clamor from investors and regulators for companies and audit firms alike to do a better job identifying risks and financial fraud earlier—most companies simply do what they have always done when reviewing the performance of their audit firms. That is an astonishing fact.

Better news is that compliance and audit executives do try to provide the audit committee a mosaic picture of the

audit firm's performance—but the emphasis is on "try." More than 70 percent of respondents give the audit committee some sort of analytical data about their audit firms: a benchmarking of audit fees, summaries of PCAOB inspection reports, analysis of SOX disclosures or comment letters from the Securities and Exchange Commission. The single most common type of analysis is a benchmarking of audit fees (55 percent provide this), but many respondents also cited a few other types of information as well. Twenty-eight percent said they provide no such help to the audit committee, and I do wonder about those people, but hey, we all have to start somewhere.

The "try" part is this: almost across the board, more people wanted to offer extra information than the number

Perhaps more interesting is that 60 percent of compliance and audit executives don't do any peer analysis of other companies and their audit firms when preparing to brief your audit committee.

who actually did—which means that a significant number of CCOs and CAEs believe they aren't giving the best quality information to their audit committees. For example, 55 percent provide a benchmarking of audit fee analysis, but 85 percent of you want to provide that data. The same holds true for every type of data we asked about, from auditor market share to SEC comment letters to SOX disclosures and more: More compliance executives want to bring that information to the audit committee than actually do.

All of these glimpses feed into a larger discussion about what the audit committee should be doing and disclosing to the public. In December the Center for Audit Quality published its Audit Committee Transparency Barometer, an in-depth look at what audit committees disclose to the public about their oversight of audit firms. The report found that even in just the last few years, from 2012 to 2014, audit committees now disclose much more. A few examples:

- » In 2012, only 16 percent of companies explained their rationales for appointing the auditor; today 31 percent do.
- » In 2012, only 26 percent of companies included the tenure of the auditor; today 50 percent do.
- » In 2012, only 1 percent of companies disclosed that the audit committee was involved in selecting the audit firm's lead partner; today 44 percent do.

Clearly, how audit committees handle the audit firm is in a state of flux. And how audit committees decide to handle the audit firm depends on what information the committee gets about the firm—and that information comes from you. ■

PCAOB to Audit Committees: Help Us Help You

By Tammy Whitehouse

Regulators are making a new push to forearm audit committees with information that will help them prod their audit firms to ask more questions and dig deeper into risky issues.

The Public Company Accounting Oversight Board has offered some new tips to audit committees on questions they should be asking their external auditors, focused not coincidentally on the issues the PCAOB most often identifies as trouble spots through its inspection process. The cheat sheet also offers suggested questions for audit committees on emerging market risks that the PCAOB has put on its radar for consideration in this year's audit inspections.

While the PCAOB has no regulatory authority over audit committees, the board does want to engage audit committees as stronger advocates for investors at the companies they serve. "We hope these insights will be useful to audit committees in your 2015 oversight activities," the PCAOB says in its guidance, dubbed the "Audit Committee Dialogue." "You may also find these insights useful in your interactions with management. You are key stakeholders in strengthening audit quality."

The guidance summarizes the top issues that have peppered inspection findings across all the major audit firms for the past several years: the audit of internal control over financial reporting; auditing of fair value and other accounting estimates; and auditors' assessment of, and responses to, risks of material misstatements in financial statements. It also addresses market risks such as the rise in mergers and acquisitions, falling oil prices, undistributed foreign earnings, and concerns about audit quality.

"If you're a true financial expert, you most likely have already thought about many of these topics," says Arnie Hanish, chairman of the audit committee for Omeros Corp. "But many audit committees are not comprised of true financial experts with deep accounting and financial reporting background. This really helps put things in perspective and frames the discussion points around the audit approach."

PCAOB inspection reports on audit firms can be "opaque," says Phil Wedemeyer, chairman of the audit committee at Atwood Oceanics and a former auditor, because the PCAOB does have limits on what it can disclose publicly under SOX. For example, audit committees can't easily read an inspection report of their own audit firm to determine how many of the findings might apply to their own company. Hence the PCAOB wants to be more helpful via other means, such as this guidance.

"To their credit, they're trying to make this useful," Wedemeyer says. "But only in the context of not getting very specific about what they're talking about." He gives the example that audit committees still aren't sure how often the PCAOB's stated concerns are focused on major audit firms, or extend into smaller firms and smaller companies as well.

Going Where PCAOB Cannot

Chris Wright, managing director at consulting firm Protiviti, says his reading of the guidance suggests the

PCAOB wants to do more than simply inform audit committee members, and perhaps to enlist them to serve as an adjunct of the PCAOB's regulatory arm. The report provides some insight, for example, into where the PCAOB sees problems in cross-border audits. That includes instances where the principal audit firm refers portions of the audit work to an affiliate in another country where the company has operations.

The PCAOB says that in 2013 inspectors found "significant problems" in more than 40 percent of such engagements at the six largest audit firms. While 2014 results are still under evaluation, "inspections continued to identify deficiencies in referred-work engagements," the report says. The PCAOB is still prohibited by some countries from performing inspections at firms whose work flows into U.S. capital markets through such cross-border audit arrangements.

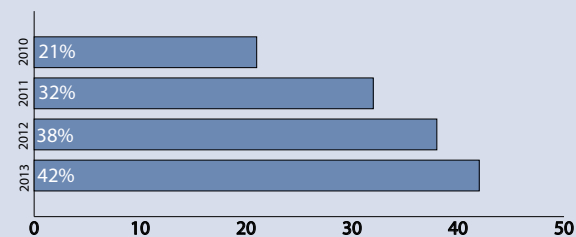
"In places like China, the PCAOB cannot inspect, but there's a lot of global activity there," Wright says. "Audit committees in that instance might have more visibility, more influence, and more oversight of external auditors than the PCAOB. The audit committee is not only welcome, but probably obligated, to question the auditors about the audit quality. The audit committee as a body has a greater ability to affect the quality control, or at least be advised of it, than the PCAOB in those countries."

Larry Rittenberg, chairman of the audit committee at Woodward Inc., says he sees auditors becoming more active on many issues the PCAOB raised in the guidance to audit committee members, including the oversight of global affiliates and the work they provide.

"We wanted to make sure they were in China for the audit of one of our units there that was undergoing its first year of SOX testing," Rittenberg says. "It was considered high risk for us, and they already had it scheduled for the U.S. principal to be there because they saw it as high risk as well." ■

DEFICIENCIES IN NON-U.S. REFERRED WORK

Of all referred work engagements inspected, see below for how the PCAOB identifies the percentage in which inspections staff identified deficiencies that resulted in the firm failing to fulfill the objectives of its role in the audit.



Source: PCAOB.

How to Thrive in the New Era of Professional Skepticism

“What can be asserted without evidence can also be dismissed without evidence.”

– Christopher Hitchens

Financial reporting is not a faith-based exercise. Trust follows evidence and verification. Auditors provide the essential verification by serving as our hired professional skeptics.

To be effective, auditors must demonstrate a questioning mind and a critical assessment of audit evidence. They must ask themselves:

- » Have I obtained sufficient evidence to verify management’s assertions regarding the fairness of its financial reporting and the effectiveness of its controls?
- » What does the evidence actually say about whether management’s assertions are correct?

These questions are of vital importance today as both public companies and their auditors are under increasing scrutiny over their procedures, particularly for audits of internal control over financial reporting as pursuant to the Public Company Accounting Oversight Board (PCAOB) [Auditing Standard No. 5](#). Indeed, many public companies have found themselves unprepared and shocked by the increased rigor of audits encouraged by the PCAOB.

In many cases, auditors have expanded the scope of testing to include numerous controls that were not tested before. They have also tasked company management to provide more complete documentation about both the design and operation of important controls and to produce additional evidence to demonstrate that these controls are effective. In the absence of adequate evidence or in the event there are inconsistencies between available evidence and management’s assertion, auditors are now much more likely to take management to task and possibly perform additional auditing procedures—although, as pointed out by PCAOB inspection findings, this does not happen as often as needed.

Those are not the only changes. Over the past few years, the PCAOB has also identified and focused on a more fundamental concern than lack of adequate evidence: Auditors have failed to consistently and diligently exercise proper levels of professional skepticism, a possible root cause of some failures to obtain suf-

ficient evidence to support their opinions.

A matter of competence and trust?

Arguably, this recent push for skepticism by the PCAOB on public company auditors has placed an increased burden on corporate managers, as well as raising concern in the business community. Though there is general agreement that the quality of public company auditing has shown a needed improvement since the Sarbanes-Oxley Act of 2002 (SOX), which established the PCAOB, some critics are openly questioning whether the PCAOB has gone too far, resulting in unnecessary and even counterproductive audit work.

In May 2015, the U.S. Chamber of Commerce’s Center for Capital Markets Competitiveness (CCMC) specifically raised these concerns in a [letter](#) to PCAOB Chairman James Doty, and James Schnurr, the Security and Exchange Commission’s (SEC) Chief Accountant, and requested a meeting with stakeholders to discuss the issues. One of the letter’s themes is that public company auditors should be able to rely more on the competence of the persons performing the control, along with the strength of other aspects of the company’s internal controls, such as the control environment and risk assessment, when deciding whether a specific control activity is effective. In other words, auditors should put more trust in management and the process.

The problem is that trust without evidence remains an act of faith.

Skepticism is here to stay

How likely is the PCAOB to ease up on its call for increased skepticism? Not very.

In December 2012, the PCAOB published its [Staff Audit Practice Alert No. 10](#), “Maintaining and Applying Professional Skepticism in Audits.” Based on inspection findings, the staff expressed concern and offered an in-depth discussion regarding auditors’ obligations to remain skeptical throughout an audit. In addition, it offered numerous examples of how auditors can improve and maintain the appropriate attitude.



The following year the Board issued a [summary inspection report](#) (2013), which identified insufficient skepticism as one of several “root causes” of audit deficiencies. Its conclusion was consistent with the findings from a similar PCAOB inspection report published in 2008. More recently, author Thomas Ray reviewed the issue in an article, “[Auditors Still Challenged by Professional Skepticism](#),” in *The CPA Journal*, noting that auditors continue to be criticized for not exercising an adequate level of professional skepticism, which is essential for an effective and reliable audit.

The issue remains an active discussion point for PCAOB board members and senior staff in their public comments and speeches—and for good reason. According to the PCAOB, the lack of professional skepticism tends to manifest itself in—among other things—acceptance of client-prepared analyses or management’s explanations without obtaining evidence to corroborate management’s assertions, as well as insufficient testing of the completeness and accuracy of source documents.

However, exercising sufficient skepticism is easier said than done. In fact, the PCAOB recognizes that there are some powerful impediments to exercising professional skepticism. These include incentives and pressures to build and maintain a long-term audit engagement, avoid significant conflicts with management, provide an unqualified audit opinion prior to the issuer’s filing deadline, and/or cross-sell other services.

Over time, auditors can also develop an inappropriate level of trust or confidence in management, feelings of pressure to avoid potential negative interactions with, or consequences to, individuals they know (that is, management), and can struggle with scheduling and workload demands.

Accordingly, the PCAOB and others continue to urge and instruct auditors how to better maintain their skeptics’ edge, and their efforts appear to be working. The result is that auditors are performing more auditing work, which manifests itself in numerous ways. These include increasing the scope of work (e.g., visiting more company locations, auditing more and smaller balances and transactions), identifying and testing process-level controls instead of limiting their efforts to higher-level management review controls, and obtaining evidence that is more reliable.

If you can’t beat ’em, join ’em

The Sarbanes-Oxley Act and the Foreign Corrupt Practices Act of 1977 obligate companies, not their auditors, to design, implement, and maintain effective internal control systems. SOX also requires that company executives take individual responsibility

for evaluating the effectiveness of their internal control over financial reporting and report any weaknesses.

Unfortunately, not all companies have done an adequate job of fulfilling these obligations. As Brian T. Croteau, deputy chief accountant for the SEC, pointedly [stated](#) in a December 2014 speech, “... based upon our cumulative efforts this year, I continue to question whether material weaknesses are being properly identified, evaluated, and disclosed.”

Surely, management must be objective when designing, implementing, and evaluating the effectiveness of its internal control systems. Perhaps management should take a cue from its auditor counterparts and become more skeptical, particularly as it

Over time, auditors can also develop an inappropriate level of trust or confidence in management, feelings of pressure to avoid potential negative interaction ...

relates to the procedures performed by company personnel in evaluating effectiveness and the adequacy of the evidence obtained and documented supporting management’s assessment. We believe that such levels of skepticism could be equally, if not more important, for financial managers.

Exercising appropriate skepticism becomes even more important as the size of the company increases and the performance and evaluation of controls is delegated throughout the organization. Dear CEO and CFO, how is it that you are satisfied that your controls are effective and that sufficient evidence has been obtained to support your written assessment?

Whether you’re ready to embrace it or not, there’s one thing you can be sure of: Regulators and inspectors will continue to put pressure on auditors and their clients to be skeptical and forthright, obtain sufficient evidence, and to improve their internal control assessment.

Key considerations for survival in a skeptical world

Arguably, forward-looking managers will get ahead of their auditors’ demands for more compelling evidence of control and compliance. To do this, they need to seek out and deploy tools and processes that enable their organizations to collect and manage the evidence they need in a more cost-effective, timely,



thorough, and less error-prone way. In our experience, we have identified a number of considerations that will improve the effectiveness of management's process.

1. Establish a single source of truth for critical information about risks, controls, and compliance

Information stored across many locations or even in a shared network drive poses challenges for many companies. A shared network drive provides a single location to store the information. But if important facts are stored or processed in different files and applications, it quickly becomes a nightmare trying to make sure that all of the representations of a key fact are identical and keeping track of which version is correct if they are not.

Most SOX and internal control teams create multiple versions of risk assessments and control processes that are shared via e-mail and stored on shared network drives. The information in these files is often inconsistent, out of date, or incorrect as the team battles version control issues and discrepancies between narratives, flowcharts, and spreadsheets.

To combat this issue, managers can leverage a number of commercially available technologies. These solutions enable companies to design and implement simple, yet powerful, single source of truth environments by allowing users to collaborate in one environment, using content seamlessly across all documents.

2. Ensure that supporting documentation is consistent by linking it directly to that single source of truth

For most companies, the current process of maintaining consistency between multiple references to the same information about risks, controls, and compliance is managed by human memory and typing skills. As a practical matter, it's nearly impossible to avoid mistakes when working with tens, hundreds, or thousands of references.

Companies commonly experience this pain with control processes that are discussed in a wide range of documents, including narratives, flowcharts, and spreadsheets. Human error causes discrepancies and conflicting information in these documents.

Managers, don't leave decisions that are susceptible to human error. Implement a solution that links information between documents so that when an update is made at the source, that change is propagated across all documents and all locations.

3. Provide simple, intuitive vehicles to help control owners remember and follow critical control procedures

Sometimes control owners don't perform management review

controls completely and accurately. Most companies rely on the professional training and memories of their control owners and managers to perform critical management review controls. However, human memories are challenged when remembering complex processes.

To alleviate this issue, make sure that the design of the control is well documented and provide the control operator with a checklist or program related to its operation. The design document should include matters such as the objective of the control, its precision (the size of error it is designed to detect or

As a practical matter, it's nearly impossible to avoid mistakes when working with tens, hundreds, or thousands of references.

prevent), how the control works, sources of information needed to perform the control and information about the nature and reliability of that information (for example, whether it is system-generated, whether it is developed by other company employees, and whether there are controls in place to ensure its completeness and reliability).

The checklist or program would assist managers in remembering and documenting all of the critical steps taken, such as:

- » Reviewing supporting information for completeness and reliability
- » Evaluating whether evidence is sufficient and whether it supports significant assumptions and inputs
- » Checking calculations for accuracy and consistency with policy and GAAP
- » Evaluating and resolving outliers or exceptions
- » Concluding on the overall result

4. Capture evidence of compliance concurrent with performance

Companies frequently collect signatures as evidence of key management review controls but sometimes fail to collect other evidence of the event or transaction until days, weeks, or months



after the fact—making it difficult to obtain such evidence and sometimes leaving evidence gaps. For example, a manager signs a schedule prepared to support financial statement amounts, but provides no other detail about what that review included. Or, management meets to review results, but it does not prepare or retain an agenda, meeting minutes, or other evidence that the meeting occurred, what it covered, and what conclusions were reached.

Building on the previous recommendation, the process can be designed to capture essential information about the control operation concurrent with its performance.

5. Consider the design of the underlying accounting process

Sometimes the line between the accounting process itself, such as the development of an accounting estimate, and the operation of the control intended to assure that the estimate is reasonable, is difficult to discern. This can be especially true in the case of significant unusual transactions or events that occur infrequently. Similar to routine transactions, significant unusual transactions also need to have controls over them. To facilitate the effective operation of the management review controls over such transactions or events, it is helpful to design a process that includes contemporaneously obtaining and documenting matters such as:

- » The significant assumptions made and the evidence obtained regarding the appropriateness of the assumptions
- » Information from outside the organization that can be relied on or should be considered, and that can be made available to the auditor
- » Rationale as to why the estimation method used is appropriate
- » Key aspects of contracts and other transaction-related documents
- » Information about the transaction or event that was shared with the board of directors and when such discussion(s) occurred
- » Direction provided by the Board, follow-up actions taken, and decisions made

Concurrently obtaining and documenting evidence during the process, transaction, or event will help to assure management that it has the necessary information to support its decision mak-

ing and the operations of its controls. It will also make it easier for the auditor to obtain the evidence needed for the audit.

It's up to you

The law, rules, standards, and interpretive guidance are clear: Company management has a responsibility to implement internal control to provide reasonable assurance of detecting and preventing material misstatement of its financial statements on a timely basis. This responsibility is not a faith-based exercise, but rather based on providing verifiable evidence that demonstrates the effectiveness of control to auditors who serve as our professional skeptics.

Over the last decade and in response to past abuses of trust, regulators have raised the evidentiary bar for public companies and admonished their auditors, who serve the public trust, to exercise greater skepticism. Their actions have arguably placed an increased burden on management and continue to generate controversy in the business community.

Though the debate on where to draw the line on this so-called skepticism will no doubt continue, the trend toward evidence-based risk management is unstoppable, and the line will likely be drawn further than many managers would prefer.

Fortunately, management has options that will enable it to not only survive, but to thrive in this brave new world of skeptics. It can begin by adopting a healthy level of skepticism and availing itself of the latest tools and processes to make its job manageable.

About the authors

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Audit Relations Continue To Be Strained

By Tammy Whitehouse

Tensions over the assessment and auditing of internal controls over financial reporting—which have been on the rise again lately—look increasingly like they will fall on the doorstep of the audit committee.

Audit committees bear ultimate responsibility for the integrity of the financial reporting process, Elizabeth Ryan, director at MorganFranklin Consulting, said at the Compliance Week 2015 conference. That means they are in the best position to facilitate communication necessary among external auditors, internal auditors, and management—and that conversation will be critical to companies marching through the minefield of audit demands, while audit firms face tough inspection findings from the Public Company Accounting Oversight Board over internal controls.

The PCAOB issued its Staff Audit Practice Alert No. 11 in October 2013 to address persistent internal control concerns found in inspections, just as most public companies were preparing to adopt the updated 2013 COSO internal control framework. That led to plenty of tension between management and auditors over how to test and document the design and effectiveness of controls amid significant change.

The biggest pains have centered on external auditors' reliance on the work of internal auditors, and the adequacy of the audit around management review controls and IT controls. The PCAOB, along with the Center for Audit Quality and the Institute of Internal Auditors, have already called on audit committees to referee those tensions and help companies navigate their way through it.

Speakers at Compliance Week 2015 echoed that message. “For audit committee members, the first place to start is to ask questions of the external audit firm,” Ryan said. “What are the inspection findings from the PCAOB? What is the audit firm doing to address those questions? That will give the audit committee some understanding of the important focus areas. There may be changes to the way the audit is performed.”

If a company's audit firm has been grilled by PCAOB inspectors over certain specific areas of internal control audits, that will give the company some warning on where auditors may place renewed focus, Ryan said. “Understanding how the firm is addressing that particular finding will shed some light on what you need to be thinking about in performing your own controls and evaluating your risks in these areas,” she said. “Are there any changes that need to occur in the way you are performing the control or collecting evidence for the control?”

Keith Wilson, deputy chief accountant for the PCAOB, said the agency issued Practice Alert 11 to clarify and highlight concerns its inspectors were finding in their reviews of audits of internal control. The alert addresses areas such as risk assessments, selecting controls for testing, and evaluating control deficiencies; plus several areas that have proved to be the biggest flash points: IT controls, management review controls, and use of the work of internal audit.

“We hear the concerns, even frustrations, from company officials over the level of audit work they are seeing,” Wilson said. “Maybe it's an uptick in the audit work or the requests from auditors for information. A lot of this gets attributed to inspections, or issues that have been driven from inspections. We have some concern that something may be getting lost in the translation. PCAOB inspections are evaluating compliance with existing standards. It's not going beyond that.”

Although the results of 2014 inspections have not yet been published, Wilson repeated what others at the PCAOB have said publicly: that inspection reports will show some firms are making improvements in some areas, but more improvements are still expected. Most firms have addressed some “basic blocking and tackling,” he said, but may still miss some finer details of compliance with auditing standards.

Talk It Out

To help companies work through the process, Wilson said companies would be wise to think in the same terms that the PCAOB is driving into auditors.

“It starts with the risks,” he said. “What are the risks of material misstatement of financial statements? What are the high risk accounts and assertions?” Then the PCAOB proceeds to put the controls in place to address those particu-



Above, Elizabeth Ryan, MorganFranklin risk & compliance director, speaks on PCAOB Practice Alert 11.

lar risks, and what evidence exists to show those controls are designed and operating effectively. “The risk drives the amount of evidence the auditor needs to support the evaluation. Higher risk controls require more evidence.”

Kevin Lavin, professional practice follow for the Center for Audit Quality, said auditors have made big strides in addressing PCAOB inspection findings and continue to work on the issue. “The public company auditing profession is working actively on many fronts to enhance the audit of internal control over financial reporting,” he said.

“We hear the concerns, even frustrations, from company officials over the level of audit work they are seeing.”

Keith Wilson, Deputy Chief Accountant, PCAOB

Lavin pointed to several trends in studies of financial restatements and investor confidence that suggest financial reporting has improved in recent years, even if the PCAOB still isn’t satisfied with auditors’ work around internal controls. “It’s important to get the big picture view,” he said. “It’s easy to get lost in the weeds.”

Auditors would welcome greater involvement from the audit committee, Lavin said, and he urged companies to “leverage the audit committee as the intermediary.” Audit committees can help facilitate the communication necessary and to reduce the audit fatigue that many companies have voiced as a concern to their auditors and regulators, he said. “They can manage expectations, and they can help influence the amount of support that internal audit needs to give to external audit.”

Lavin also advised consider appointing a “central facilitator,” a person to channel all information requests from auditors to management. Companies would also benefit from enhanced coordination between external auditors and internal auditors—for example, perhaps by performing joint walkthroughs to reduce duplication of efforts. Companies should make increased use of templates provided by external audit firms to assure their internal efforts can be relied upon by external auditors, he said.

Ryan agreed that joint walkthroughs and robust communication to coordinate the efforts of internal and external auditors is key to working through the tension. “Start the conversation as early as possible,” she said. “You want to understand and define the roles and responsibilities of each party: who’s going to be testing what controls, and where external auditors are relying on internal auditors for direct assistance.”

Mary Spencer, director of financial compliance at RockTenn, said at the CW conference that the key to successful Sarbanes-Oxley compliance has been to view SOX compliance as a project management exercise—and one that changes annually at that. “SOX is always going to be a project, and it’s never the same twice,” she said. “The risk assessment, the review, the people, the environment, the technology: They are all changing.” ■

QUESTIONS FOR YOUR AUDITOR

Below, the PCAOB reaches out to audit committees, providing advice on what to ask the auditor in regard to certain key issues.

Auditing Internal Control Over Financial Reporting

- » What are the points within the company’s critical systems processes where material misstatements could occur? How has the audit plan addressed the risks of material misstatement at those points? How will your auditor determine whether controls over those points operate at a level of precision that would prevent or detect and correct a potential material misstatement?
- » What is your auditor’s approach to evaluating the company’s controls over financial reporting for significant unusual transactions or events, such as the acquisition of assets and assumption of liabilities in a business combination, divestitures, and major litigation claims?
- » If the company enters into a significant unusual transaction during the year, how will your auditor adjust the audit plan, including the plan for testing ICFR related to the transaction? For example, how would the company’s acquisition of a significant enterprise during the third quarter affect the audit plan for the year? How might your auditor’s materiality assumptions change? Would the audit plan focus on different systems and controls than originally planned? How would your auditor test controls over the systems used to generate information for recognizing and measuring the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree? How would the internal control over financial reporting of the acquired company be considered? Asking about the effectiveness of controls before such transactions and events occur will signal to your auditor that preparedness is a priority, as will asking similar questions about new systems and processes.
- » If the company or your auditor has identified a potential material weakness or significant deficiency in internal control, what has been done to probe the accuracy of its description? Could the identified control deficiency be broader than initially described? Could it be an indication of a deficiency in another component of internal control?

Auditing Estimates, Including Fair-Value Measurements, and Disclosures

- » What does your auditor do to obtain a thorough understanding of the assumptions and methods the company used to develop critical estimates, including fair value measurements?
- » What is your auditor’s approach to auditing critical accounting estimates, such as allowances for loan losses, inventory reserves, and tax-related estimates?

Source: PCAOB.



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