



# Audit Committee *Resource* Guide



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# Contents

**Message from Greg Durant** ..... 1

**Foreword**..... 2

## SECTION ONE

**Audit committee leading practices and trends**..... 4

## SECTION TWO

**Audit committee composition**..... 7

- Audit committee charter and agenda
- Independence of audit committee members
- Financial literacy

## SECTION THREE

**Key responsibilities**..... 15

- Interaction with the internal auditors
- Risk assessment and oversight
- Fraud and internal control over financial reporting
- Review of earnings press releases and use of non-GAAP financial measures
- Code of ethics
- Complaint hotline procedures

## SECTION FOUR

**Interaction with the independent auditor** ..... 33

- Auditor independence
- Fee disclosure
- Evaluation of the independent auditor

## SECTION FIVE

**Education and evaluation**..... 46

- Board education
- Audit committee performance evaluation

## SECTION SIX

**Additional responsibilities**..... 50

## Appendices

Appendix A	Sample audit committee charter	53
Appendix B	Planning tool: Audit committee calendar of activities	62
Appendix C	Financial literacy self-assessment tool	70
Appendix D	Audit committee performance evaluation	81



## Message from Greg Durant

Vice Chairman and Managing Partner – Clients & Industries, Deloitte LLP

With audit committees under increased scrutiny and the ever-changing regulatory landscape, setting the tone at the top has never been more important.

As an audit committee member, your organization and its shareholders rely on your judgment to appropriately oversee areas such as risk, compliance, financial reporting, and corporate resources. In the pages that follow, we offer practical considerations and resources to help guide your efforts.

To carry out your responsibilities, you need a clear understanding of what is expected of you as an audit committee member according to your organization's charter and relevant regulatory requirements. As an example, both the NYSE and NASDAQ have explicit standards with respect to audit committee charters, independence, and financial literacy. Knowing the nuances of each regulation, as well as other relevant regulatory considerations of the SEC and the PCAOB, will help you and your committee members fulfill your responsibilities. Key responsibilities of the audit committee include:

- Having an effective relationship with management, internal auditors, and the independent auditor
- Taking a "risk-intelligent" governance approach
- Overseeing the establishment of appropriate controls and antifraud programs
- Overseeing dissemination of earnings press releases, financial information, and earnings guidance
- Monitoring a robust code of ethics
- Establishing a process for investigating allegations, especially those against senior management.

In each of these areas, there are numerous considerations to be aware of should an issue arise. To assist you, the *Audit Committee Resource Guide* includes several sample questions and applicable regulatory requirements.

Audit committees are directly responsible for the appointment, compensation, and oversight of independent auditors, and, therefore, you must be aware of numerous regulatory guidelines related to independence, fees, and evaluations. The *Audit Committee Resource Guide* consolidates and compiles several related topics for your reference.

Finally, board and audit committee education and performance evaluation are topics whose importance cannot be overstated, particularly given the enhanced focus on board and audit committee responsibilities. While the NYSE, NASDAQ, and SEC provide standards for board education, there are no specific guidelines for assessing an audit committee's performance. Audit committees do, however, have access to an array of leading practices, tools, and resources, many of which are available through Deloitte's [Center for Corporate Governance](#) and other external organizations.

On a personal note, I hope that the *Audit Committee Resource Guide* helps clarify your role and gives you a better understanding of how to be an even more effective audit committee member. If there is any way Deloitte can help, please don't hesitate to ask.

Regards,

**Greg Durant**

Vice Chairman and Managing Partner – Clients & Industries, Deloitte LLP

# Foreword

As the role of the audit committee has continued to evolve, it has become increasingly important for audit committee members to remain up to date and aware of changes to their responsibilities. Deloitte is committed to providing audit committee members with resources and leading practices to help fulfill their responsibilities.

The *Audit Committee Resource Guide* presents an overview of audit committee requirements for U.S. public companies and is a reference guide for seasoned and new audit committee members as they address areas such as risk oversight, interaction with the internal auditor and independent auditor, review of earnings press releases, and oversight of internal controls and financial reporting.

Audit committee members must have a clear understanding of what is expected of them pursuant to their organizations' charters and regulatory requirements. In each section of the *Audit Committee Resource Guide*, Deloitte has outlined the rules set forth by the NYSE, the NASDAQ, the SEC, and other regulators, as well as leading practices and questions for audit committees to consider.



You can instantly access the *Audit Committee Brief* through a free, easy-to-use tablet app. Deloitte's new Audit Committee Resources application is available in the iTunes App Store. New issues of the brief are made available for download each month and feature useful multimedia content not available in the print version. The application also includes an interactive edition of the popular *Audit Committee Resource Guide*.

Click [here](#) or visit the App Store and search for "Deloitte Audit Committee Resources" to download the application.



In addition to providing guidance and common practices, the guide references relevant tools and resources, many of which are available on Deloitte's [Center for Corporate Governance website](http://www.corpgov.deloitte.com). This website compiles recent research and information for directors and board committees and is available at [www.corpgov.deloitte.com](http://www.corpgov.deloitte.com).

Please note that the *Audit Committee Resource Guide* is not a comprehensive view of all audit committee requirements. Companies should review applicable SEC and NYSE or NASDAQ exchange rules and regulations and consult a qualified professional adviser to understand their full compliance needs.

If you have any questions or comments about this guide, please contact [auditcommittee@deloitte.com](mailto:auditcommittee@deloitte.com).



- Visit the Center for Corporate Governance at [www.corpgov.deloitte.com](http://www.corpgov.deloitte.com) for the latest information for boards of directors and their committees.



- To subscribe to the *Audit Committee Brief* and other Deloitte publications, go to <https://deloitte.zettaneer.com/subscriptions>.

Section One

# Audit committee leading practices and trends

# Audit committee leading practices and trends

The following is a summary of certain leading practices for audit committees. It is not all inclusive, but it can be used to help assess audit committee practices and to discuss agendas and other considerations.

Committee dynamics	Risk oversight
<ul style="list-style-type: none"> <li>• Focus on committee composition, including independence, financial expertise, risk management, broad business or leadership experience, and succession planning.</li> <li>• Limit the number of audit committee members to four or five to optimize effectiveness.</li> <li>• Oversee and respond to enterprise risk management activities.</li> <li>• Conduct an annual committee self-evaluation.</li> <li>• Consider periodically rotating audit committee members, including the chairman.</li> <li>• Encourage discussion, rather than presentation, at meetings.</li> <li>• Participate in audit committee education activities.</li> <li>• Engage independent advisers when needed.</li> </ul>	<ul style="list-style-type: none"> <li>• Increase the focus on risk oversight and assessment.</li> <li>• Avoid becoming overly dependent on forms or tools for monitoring risk.</li> <li>• Periodically reassess the list of top risks, determining who in management and which board committee is responsible for each.</li> <li>• Evaluate information technology (IT) projects, including IT milestones and reporting against them, especially for IT transformation.</li> <li>• Consider post-acquisition reviews, including risks, relevant integration milestones, and ROI analysis to evaluate the reliability of initial acquisition assumptions.</li> <li>• Have appropriate leaders in the business make a presentation at a board or audit committee meeting to enhance the members' understanding of the business and risks and to evaluate the depth of talent.</li> </ul>
Self-assessment and evaluation of effectiveness	Oversight of internal controls and financial reporting
<ul style="list-style-type: none"> <li>• Perform a self-assessment in a thorough manner rather than as a compliance exercise.</li> <li>• Consider using self-assessment results as a catalyst to re-engineer processes, procedures, and agendas, which should influence where the audit committee spends its time.</li> <li>• Communicate with the board on activities and recommendations.</li> <li>• Align audit committee meeting materials and agendas with priority areas:               <ul style="list-style-type: none"> <li>– Put significant areas first in advance materials and on the agenda.</li> <li>– Include matters for review and comment.</li> <li>– Present compliance matters, standard reports, and informational items at the end of advance materials and meetings; they may not need to be discussed at the meeting.</li> <li>– Meetings should be preceded or followed by private and executive sessions, absent members of management.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Understand key controls and reporting risk areas as assessed by financial management, the internal auditors, and the independent auditor.</li> <li>• Emphasize oversight of corporate taxes, an area where high-risk and high-dollar decisions are made.</li> <li>• Leverage the value of internal controls beyond compliance.</li> <li>• Consider levels of authority and responsibility in key areas, including pricing and contracts, acceptance of risk, commitments, and expenditures.</li> <li>• Understand complex accounting and reporting areas and how management addresses them.</li> <li>• Understand significant judgments and estimates used by management and their impact on the financial statements, such as fair-value accounting and related assumptions.</li> <li>• Anticipate and understand how pending financial reporting and regulatory developments may affect the company, particularly its talent needs.</li> </ul>

#### Interaction with the independent auditor

- Exercise ownership of the relationship with the independent auditor.
- Get to know the lead partners and meet periodically with specialists (e.g., tax, IT, actuarial, SEC).
- Establish expectations regarding the nature and method of communication, as well as the exchange of insights.
- Engage in regular dialogue outside the scheduled meetings.
- Set an annual agenda with the independent auditor.
- Focus on independence, including a preapproval process.
- Provide formal evaluations and regular feedback.

#### Partnership with the CFO and other management

- Focus on the tone at the top, culture, ethics, and hotline monitoring.
- Conduct annual evaluations.
- Engage in the identification of potential issues.
- Understand plans to address new accounting and reporting requirements.
- Provide input to management's goal-setting process.
- Discuss succession planning for the CFO and staff.
- Conduct pipeline and staff reviews, including identification of high-potential personnel.

#### Executive (private) sessions

- Schedule regular sessions with the internal auditors, the independent auditor, and management.
- Provide clear objectives and expectations for each meeting.
- Prepare specific topics and questions.
- Understand the response to and resolution of each issue raised.

#### Executive compensation

- Periodically conduct meetings with the compensation committee regarding management incentives.
- Work with the compensation committee to consider the incentive structure and whether it contributes to increased fraud risk.
- Increase focus on the compensation of officers and directors, including the appropriate use of corporate assets such as planes and apartments.

#### Interaction with the internal auditors

- Assess whether the internal auditors have a direct reporting line to the audit committee and an indirect line to management for administrative activities.
- Be involved with the internal audit risk assessment and audit plans, including activities and objectives regarding internal control over financial reporting.
- Conduct annual evaluations.
- Understand internal audit staffing and succession planning.

#### Orientation and continuing education

- Address board education in the company's corporate governance guidelines to be consistent with NYSE listing standards.
- Provide orientation of new members that involves company executives, internal audit, and the independent auditor.
- Offer ongoing one-on-one or committee-level education opportunities.
- Consider offering continuing education in specialized or regulated industry matters, reporting, operations, and related topics.

Section Two

# Audit committee composition

Audit committee charter and agenda

Independence of audit committee members

Financial literacy

## Audit committee composition

Periodically, audit committees should review their composition and membership to confirm that they encompass the knowledge and experience needed to be effective. In addition to industry knowledge, committee members should have a strong grasp of key financial reporting and accounting issues, such as revenue recognition, pensions and other post-employment benefits, financial instruments, other critical accounting policies, and internal controls.

### Audit committee charter and agenda

An annual review of the charter is recommended for all audit committees, and is required for NASDAQ-listed entities. Updates may be necessary as a result of:

- Changes in regulatory or legal requirements
- The board's delegation of new responsibilities to the audit committee or reassignment of certain responsibilities that are not required of the audit committee by law or regulation
- Changes in the company's bylaws that affect the composition of the committee or how members are appointed
- Identification of practices the committee wants to include among its responsibilities.

To help execute its role in a timely and efficient manner, the audit committee may use the responsibilities outlined in the charter to develop an annual calendar and meeting agendas. In addition to addressing responsibilities prescribed by regulation, the charter should address the audit committee's key recurring responsibilities as well as its responsibility for significant transactions and unusual events. The charter also should allow the committee to meet outside the official calendar when needed. Concurrent with the charter review, the committee can examine its calendar of activities and consider modifications based on the changes to the charter. The committee may also reconsider the frequency and timing of activities already on the calendar.

In updating the charter and calendar, it may be helpful to consult with management, the internal auditors, and the independent auditor. When appropriate, the committee should also seek legal counsel in reviewing the charter and the calendar.

**Tools and resources.** Deloitte has developed a template for an audit committee charter based on the practices of Fortune 1000 companies and the requirements of the SEC, the NYSE, and NASDAQ. The template, which is located in [Appendix A](#), can be used with the calendar planning tool in [Appendix B](#).

***Overview of audit committee charter requirements.***

SEC rules require public companies to disclose in their proxy statements whether the board has adopted a written charter for the audit committee and, if so, to disclose whether a copy of the charter is available on the company's website and to provide the company's Web address.

Both the NYSE and NASDAQ outline minimum requirements for the content of the audit committee charter. Refer to the charter template in Appendix A for more detail on these responsibilities.

***Director qualification disclosure requirements.*** The SEC requires proxy disclosures about the background and experience of directors and nominees. The disclosure should include information about the experience, qualifications, and attributes considered in the nomination process and the reasons why individuals should sit on the company's board. Disclosures regarding individual board committee qualifications are not required, but companies may want to consider including the qualifications of the member as discussed during the committee selection process as a part of the overall board qualification disclosure.

**Independence of audit committee members**

The independence of board and audit committee members should be continuously maintained and reviewed at least annually and more often as necessary. Listed companies should have policies in place to facilitate timely identification of changing relationships or circumstances that may affect the independence of audit committee members. Many companies require directors to complete an independence questionnaire when appointed to the board and annually thereafter, and to notify the company of any changes that may affect independence. For audit committee members, these questionnaires should be tailored to reflect the independence criteria of either the NYSE or NASDAQ. Companies may want to involve legal counsel in assessing the independence of directors.

The SEC requires audit committee members of listed companies to be independent and sets forth the criteria for independence. The NYSE and NASDAQ listing standards also outline criteria for director independence.

**Overview of the requirements.** Rule 10A-3 of the Securities Exchange Act of 1934 (the Exchange Act) specifies general criteria for independence. Under these criteria, other than in his or her capacity as a member of the audit committee, board, or other board committee, an audit committee member may not:

- Accept any consulting, advisory, or other compensatory fee from the issuer or any subsidiary thereof
- Be affiliated with the issuer or any subsidiary thereof.

The SEC's rule prohibits any compensation other than that accepted as a board or committee member, whether it is received directly or indirectly. Prohibited compensation includes, but is not limited to, compensation for services rendered by a law firm, accounting firm, consulting firm, investment bank, or similar entity in which the audit committee member is a partner, executive officer, or the equivalent. The SEC's prohibition does not cover payments made by the company in the ordinary course of business for services other than legal, accounting, consulting, investment banking, or financial advisory services. Prohibited indirect compensation includes payments to spouses, minor children or stepchildren, and adult children or stepchildren who share a home with the audit committee member.

The SEC's rule also includes a definition of "affiliate" for the purpose of determining independence. An affiliate is a "person that directly, or indirectly through one or more intermediaries, controls or is controlled by or is under common control with the person [or entity] specified." The rule also states that the following are considered affiliates: anyone who is an executive officer, both a director and an employee, a general partner, or a managing member of an affiliate.

## Audit committee charter requirements

### NYSE

The NYSE requires the audit committee charter to include oversight of:

- The integrity of the company's financial statements
- The company's compliance with legal and regulatory requirements
- The independent auditor's qualifications and independence
- The performance of the company's independent auditor and internal audit function.

In addition, charters of NYSE-listed companies must set forth the audit committee's responsibility to prepare the audit committee report for the proxy; discuss policies with respect to risk assessment and management; discuss the company's earnings press releases and information provided to analysts and rating agencies; meet in private sessions with management, the internal auditor, and the independent auditor; assess the audit committee's performance annually; comply with Rule 10A-3(b) of the Exchange Act; and various other responsibilities specified by the NYSE listing standards.

### NASDAQ

The NASDAQ requires an annual review and assessment of the adequacy of the formal written charter.

The charter should include the committee's purpose of overseeing the company's accounting and financial reporting processes and the audits of its financial statements. The charter should also address the scope of its responsibilities and how the committee carries out its responsibilities, including structure, processes, and membership requirements. The responsibilities in the charter must include:

- Obtaining a written statement from the independent auditor delineating all relationships between the auditor and the company, consistent with PCAOB Ethics and Independence Rule 3526
- Communicating with the independent auditor with respect to any relationships or services that may affect the auditor's objectivity and independence
- Overseeing the independence of the auditor
- The responsibilities outlined by Rule 10A-3(b) of the Exchange Act.

The definition of "control" is consistent with the definition in the Exchange Act, as amended: "The possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person [or entity], whether through the ownership of voting securities, by contract, or otherwise." The SEC's rule includes a safe harbor for a person who is not an executive officer of an entity and who does not hold at least 10 percent of the entity's shares. Such a person would not be considered to have control of the entity.

In addition, the SEC's rule includes exceptions for certain overlapping board relationships, initial public filers, investment companies, and foreign filers. With respect to overlapping board relationships, an audit committee member may sit on the board of a listed company and that of any affiliate if the member otherwise meets the independence requirements of each entity.

The NYSE and NASDAQ listing standards incorporate the SEC's independence requirements. Both also define their own requirements for director independence.

## Independence requirements

### NYSE – Not independent if:

The director is an employee, or an immediate family member is an executive officer, of the listed company or was during the past three years.

The director or an immediate family member received more than \$100,000 in direct compensation from the listed company in any 12-month period during the previous three years, except for director fees and other permitted payments.

The director or an immediate family member is a current partner of the company's internal or independent auditor; the director is a current employee of such a firm; the director has an immediate family member who is a current employee of such a firm and personally works on the company's audit; or the director or an immediate family member was, within the previous three years (but is no longer), a partner or employee of such a firm and personally worked on the company's audit during that time.

The director is a current employee, or an immediate family member is a current executive officer, of another company that made payments to, or received payments from, the listed company for property or services in an amount that, in any one of the previous three fiscal years, was in excess of the greater of \$1 million or two percent of the other company's consolidated gross revenues.

### NASDAQ – Not independent if:

The director is an employee, or a family member is an executive officer, of the listed company or was during the previous three years.

The director or a family member accepted compensation payments in excess of \$120,000 from the listed company in any 12-month period during the previous three years, except for director fees and other permitted payments.

The director or a family member is a current partner of the listed company's independent auditor or was a partner or employee of the listed company's independent auditor who worked on the company's audit during the previous three years.

The director or a family member is a partner, controlling shareholder, or executive officer of another organization that received from, or made payments to, the listed company for property or services in an amount in excess of the greater of 5 percent of the recipient's gross revenues or \$200,000, or did so during the previous three years (with certain limited exceptions).

### Audit committee financial literacy recommendations

- Self-assessment should be thorough, not merely a compliance exercise, and should be repeated periodically.
- Members should understand auditing, accounting, and financial reporting issues relevant to the company and how management and the independent auditor address them.
- Committees should anticipate and understand how pending financial reporting and regulatory developments may affect the company, and particularly its talent needs.
- Members should focus on committee composition, including independence, financial expertise, risk management, broad business or leadership experience, and succession planning.

## Financial literacy

In designating an audit committee financial expert (ACFE), the board of directors should abide by the NYSE and NASDAQ requirements.

**NYSE requirement.** The NYSE requires all audit committee members to be “financially literate” as interpreted by the business judgment of the company’s board, or to become financially literate within a reasonable period after being appointed to the committee.

In addition, at least one member must have “accounting or related financial management expertise,” again as interpreted by the board. Although the NYSE listing standards do not require the audit committee to include a person who satisfies the SEC’s definition of an ACFE, a person so designated will satisfy the accounting or related financial-management expertise required by the NYSE.

**NASDAQ requirement.** NASDAQ listing standards require all audit committee members to be able to read and understand financial statements at the time of their appointment to the committee. NASDAQ also requires at least one audit committee member to be “financially sophisticated.” Financial sophistication may be obtained through employment experience in finance or accounting, professional certification in accounting, or any comparable experience, including current or past employment as a chief executive officer, chief financial officer, or other senior officer with responsibility for financial oversight. Like the NYSE, NASDAQ does not require an ACFE on the audit committee, but if the board determines an individual is an ACFE, that individual is also deemed financially sophisticated.

The board of directors should also consider the SEC’s five attributes and prescribed methods of acquiring this expertise. After seeking appropriate legal counsel, the board should decide whether at least one member is an ACFE. Many companies have multiple ACFEs. In making this determination, the board of directors may have audit committee members complete a questionnaire or use the [American Institute of Certified Public Accountants \(AICPA\) decision tree](#) to evaluate whether an individual meets the criteria.

Although ACFEs are not expected to lose that expertise, it is important for the audit committee members to invest the time needed to understand the latest developments in financial reporting and auditing standards. Many boards have a formal process for assessing the financial literacy of their audit committee members and revisit the ACFE designation periodically. It is also important for the board and the audit committee to consider succession planning, with an emphasis on the need for members with financial experience. Refer to the board education section for a discussion of common practices related to general board education and financial literacy training.

### Questions for audit committees to consider

- Are audit committee members completing routine financial literacy self-assessments?
- Does the financial literacy self-assessment reflect recent developments?
- Are modifications to the committee's education plan necessary?
- Are the audit committee's training and education programs designed to maintain financial literacy?

**Overview of the requirements.** The SEC requires an issuer to disclose whether at least one ACFE serves on the audit committee. The SEC defines the ACFE as an individual who the board of directors determines possesses all of the following attributes:

1. An understanding of financial statements and generally accepted accounting principles (GAAP)
2. An ability to assess the general application of GAAP in connection with the accounting for estimates, accruals, and reserves
3. Experience preparing, auditing, analyzing, or evaluating financial statements that present a breadth and level of complexity of accounting issues generally comparable to what can reasonably be expected to be raised by the issuer's financial statements, or experience actively supervising those engaged in such activities
4. An understanding of internal control over financial reporting
5. An understanding of the audit committee's functions.

The rule indicates that the attributes may be acquired by:

- Education and experience as a principal financial officer, principal accounting officer, controller, public accountant, or auditor, or experience in positions that involve similar functions
- Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor, or someone performing similar functions

- Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing, or evaluation of financial statements
- Other relevant experience.

These criteria permit a chief executive officer who "actively supervised" the specified individuals to qualify as an ACFE if he or she possesses the five necessary attributes.

Disclosure of whether at least one audit committee member is an ACFE is required in the annual report filed on Forms 10-K, 10-KSB, 20-F, or 40-F and, if the committee does not have such an expert, why it does not. The SEC's rule also requires disclosure of the name of the ACFE and whether that individual is independent of management. It is at the company's discretion to disclose if more than one member meets the criteria.

The SEC rule states that designation as an ACFE does not imply that an individual is an expert for any purpose under the Exchange Act or otherwise. Furthermore, it does not elevate the duties, obligations, or liabilities of that member or lessen those of other board and audit committee members.

**Tools and resources.** Deloitte has developed various resources to help boards assess the financial literacy of audit committee members. Deloitte's *Financial Literacy Self-Assessment Tool* can be used for this purpose. This tool should be used in conjunction with other processes to assess an individual's financial literacy. Also refer to the [Audit Committee](#) section on the [Center for Corporate Governance website](#).

Section Three

# Key responsibilities

Interaction with the internal auditors

Risk assessment and oversight

Fraud and internal control over financial reporting

Review of earnings press releases and use of non-GAAP financial measures

Code of ethics

Complaint hotline procedures

## Key responsibilities

### Interaction with the internal auditors

An effective relationship between the audit committee and the internal auditors is fundamental to the success of the internal audit function. It is important for audit committees to assess whether the internal auditor's priorities are aligned with the audit committee's, such as monitoring critical controls and identifying and addressing emerging risks. The specific expectations for internal audit functions vary by organization, but leading practices include the following elements:

- Objectively monitor and report on the health of financial, operational, and compliance controls.
- Provide insight into the effectiveness of risk management.
- Offer guidance regarding effective governance.
- Become a catalyst for positive change in processes and controls.
- Deliver value to the audit committee, executives, and management in the areas of controls, risk management, and governance to assist in the audit committee's assessment of the efficacy of programs and procedures.
- Coordinate activities and share perspectives with the independent auditor.

In support of these objectives, audit committees should take several steps to facilitate a mutually beneficial relationship with the internal auditors:

- Hold regular private sessions with the internal auditors (required for NYSE-listed companies).
- Be available when contacted by the chief audit executive (CAE).
- Engage in discussions regularly; make the reporting relationship a substantial and communicative one.
- Actively participate in discussing goals and evaluating the performance of the CAE; these responsibilities should not be delegated solely to the CFO or CEO.
- Challenge the CAE and the internal audit department by setting high expectations, communicating those expectations clearly, and holding the department accountable for meeting them.
- See that the internal auditors have appropriate stature and respect and are visibly supported by senior management throughout the organization.
- Support the CAE, providing guidance if needed and assistance when he or she reports potential management lapses.

### Questions for audit committees to consider

- Does internal audit have a clearly articulated strategy that is reviewed periodically and approved by the audit committee?
- Does internal audit have a clear set of performance expectations that are aligned with the success measures of the audit committee, and that are measured and reported to the audit committee?
- Does internal audit have a charter that is periodically reviewed and approved by the audit committee? Does internal audit operate in accordance with its charter?
- Is the internal audit plan aligned to the key risks of the organization and other assurance activities? Is internal audit's risk assessment process appropriately linked to the company's enterprise risk management activities?
- In delivering the internal audit plan, is internal audit flexible and dynamic in promptly addressing new risks and the needs of the audit committee?
- Does internal audit organize or perform peer reviews or self-assessments of its performance and report the results to the audit committee?
- Is internal audit appropriately funded and staffed?
- Is internal audit staffed with the appropriate mix of professionals to achieve its objectives?
- Is internal audit sufficiently independent of management?
- Is the CAE respected as an adviser to the audit committee and management on emerging risks?
- Is internal audit highly regarded and respected in the organization?
- Is the level of assurance provided by internal audit and its interaction with other assurance sources clear and appropriate for the audit committee?
- Does internal audit meet regularly with the external auditors to discuss risk assessments, the scope of procedures, or opportunities to achieve greater efficiencies and effectiveness in the company's audit services?
- Are issues identified and reported by internal audit appropriately highlighted to the audit committee, and is the progress toward effective completed management actions tracked and reported?
- Is internal audit timely and proactive in the conduct and reporting of issues and in addressing them with management?
- Are reports and other communications from internal audit to the audit committee of an appropriate standard and do they provide value?

## Internal audit oversight

### NYSE requirements

The audit committee charter must include oversight of the internal audit function as one of its purposes.

The audit committee's regular report to the board of directors should include issues involving the performance of the internal audit function.

The audit committee must meet separately with the internal auditors.

### NASDAQ requirements

The audit committee oversees the accounting and financial reporting processes of the company. Note that oversight of internal audit is often one component in meeting this requirement.

Through effective communication, the audit committee can help the CAE fully understand and achieve what is expected of him or her. Several questions help assess the current or prospective CAE's ability to perform at a consistently high level:

- Was the audit committee involved in selecting the CAE?
- Was the bar set high enough to select the caliber of candidate needed?
- Does the audit committee have reasonable and appropriate expectations?
- Does the CAE have the right mix of experience and capabilities, including industry knowledge and business acumen, to understand the company's risks?
- Does the CAE have a professional certification, such as certified internal auditor, and participate in relevant continuing education programs?
- Does the internal audit function have a quality improvement program?

When the internal audit function's direct reporting line is to the audit committee, it allows the internal auditors to remain structurally separate from management and enhances objectivity. This also encourages the free flow of communication on issues and promotes direct feedback from the audit committee on the performance of the CAE. There are several ways the audit committee can oversee the internal audit function. The Institute of Internal Auditors (IIA) provides the following 10-point checklist of considerations for audit committees in overseeing the internal auditors:

1. The audit committee engages in an open, transparent relationship with the CAE.
2. The audit committee reviews and approves the internal audit charter annually.
3. As a result of discussions with the CAE, the audit committee has a clear understanding of the strengths and weaknesses of the organization's internal control and risk management systems.
4. Internal audit is sufficiently resourced with competent, objective internal audit professionals to carry out the internal audit plan, which has been reviewed and approved by the audit committee.

5. Internal audit is empowered to be independent by its appropriate reporting relationships to executive management and the audit committee.
6. The audit committee addresses with the CAE all issues related to internal audit independence and objectivity.
7. Internal audit is quality-oriented and has in place a quality assurance and improvement program.
8. The audit committee regularly communicates with the CAE about the performance and improvement of the CAE and internal audit.
9. Internal audit reports are actionable, and audit recommendations and/or other improvements are satisfactorily implemented by management.
10. The audit committee meets periodically with the CAE without the presence of management.

In addition to the suggestions above, a leading practice of the audit committee is to review and evaluate the status of the enterprise-wide risk assessment and the related audit plans, including evaluating the progress and results of the audit against the original plans and any significant changes made to those plans.

The IIA's Standards for Professional Practice of Internal Auditing mandate that the internal auditors maintain a certain level of independence from the work they audit. This means that an internal auditor should have no personal or professional involvement with the area being audited and should maintain an impartial perspective on all engagements. Internal auditors should have access to records and personnel when necessary, and they should be allowed to employ appropriate investigative techniques without impediment.

**Overview of the requirements.** The NYSE listing standards require audit committees to oversee the internal audit function and to note this responsibility in their charters.

**Tools and resources.** Deloitte's [Center for Corporate Governance](#) provides a number of resources to help audit committees understand the internal audit function and their oversight responsibilities.

The IIA's [The Audit Committee: Purpose, Process, Professionalism](#) provides insight into the audit committee's interaction with the internal audit function and a list of questions for audit committees to consider.

The AICPA's [Audit Committee Toolkit](#) includes "Guidelines for Hiring the Chief Audit Executive," which discusses considerations in recruiting and interviewing internal audit directors.

### Dodd-Frank impact

The Dodd-Frank Wall Street Reform and Consumer Protection Act requires certain bank holding companies, and certain other non-bank financial companies, to have a separate risk committee that must include at least one risk management expert, as defined in the act. The Federal Reserve Board issued its notice of proposed rulemaking, which will require U.S. banks and bank holding companies with greater than \$50 billion in assets, those with greater than \$10 billion in assets that are publicly traded, and non-bank financial companies designated as systemically important to establish a board risk committee with a formal written charter approved by the company's board of directors. Companies need to consider how risk oversight is managed, as the full board remains accountable for risk oversight and other committees may still play a significant role; for example, the audit committee's role in overseeing financial risks.

## Risk assessment and oversight

Risk oversight has taken on increased importance not only for audit committees, but for full boards. Many boards have recently or are reconsidering the risk governance structure and which committees have the expertise to oversee particular risks.

The SEC requires disclosure regarding the board's role in risk oversight. Examples include whether the entire board is involved or whether risk oversight is executed by a particular committee, and whether the employees responsible for risk management report directly to the board. The SEC considers risk oversight a key responsibility of the board, and this disclosure will improve investors' and shareholders' understanding of this role.

Audit committees are responsible for overseeing the process for identifying and addressing financial risks. However, the responsibility for other risks can be moved to other board committees that have the appropriate expertise; for example, human resource and compensation risks can be overseen by the compensation committee. Nonetheless, the full board has the ultimate responsibility for risk oversight and should discuss the organization's most material risks regularly.

The NYSE listing standards require the audit committee to discuss the company's risk assessment and risk management policies with management. The commentary clarifies that 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 exposure and discuss the guidelines and policies for addressing these areas. Consequently, risk oversight has been on the agenda of audit committees for a number of years.

The requirement relates specifically to financial risks, but these risks are often a consequence of other sources of risk, such as those disclosed in the company's Forms 10-K and 10-Q. These may include strategy, operations, and compliance with environmental, health, safety, legal, and regulatory requirements. Many audit committees have taken the lead in overseeing the company's overall risk management program.

Deloitte has identified six distinct areas of focus for the full board in helping to enable a risk-intelligent governance approach:

1. Define the board's risk oversight role.
2. Foster a risk-intelligent organizational culture.
3. Help management incorporate risk intelligence into its organizational strategy.
4. Help define the risk appetite.
5. Execute a risk-intelligent governance process.
6. Benchmark and evaluate the governance process.

### Questions for audit committees to consider

When the audit committee is considering the effectiveness of the company's enterprise risk management—the process of planning, organizing, leading, and controlling activities to minimize the effect of downside risk on the organization—they may consider asking the following questions:

What are the company's policies and processes for assessing and managing major financial risk exposures on an integrated, enterprise-wide basis?

What are the key risks, vulnerabilities, and plans to address them?

Has the company defined its risk appetite with the board's input and approval?

How capable is the company of preparing for, responding to, and recovering from major financial risk exposures?

How do our various board committees oversee risk? Is there appropriate coordination and communication?

Is the full board participating in risk oversight and discussing the most material risks and how they are being monitored?

Does the board consider the relationship between strategy and risk?

Are we getting the information we need across the organization for key decisions?

Does the scenario planning include both individual and aggregate risk views?

What mechanisms does management use to monitor emerging risks? What are the early warning mechanisms, and how effective are they? How, and how often, are they calibrated?

Which framework has management selected for the risk management program? What criteria were used to select it?

What is the role of technology in the risk management program? How was it chosen, and when was it last evaluated?

What is the role of the tax department in the risk management program? Are we taking steps to gain a high-level understanding not only of tax risk, but also of the benefits a robust tax risk management program can offer?

### Nine fundamental principles of a risk intelligence program

1. A common definition of risk addressing both value preservation and value creation is used consistently throughout the organization.
2. A common risk framework supported by appropriate standards is used throughout the organization to manage risks.
3. Key roles, responsibilities, and authority related to risk management are clearly defined and delineated.
4. A common risk management infrastructure is used to support the business units and functions in their risk responsibilities.
5. Governing bodies such as boards and audit committees have appropriate transparency and visibility into the organization's risk management practices.
6. Executive management has primary responsibility for designing, implementing, and maintaining an effective risk program.
7. Business units are responsible for their business and the management of risks they take within the risk framework established by executive management.
8. Certain functions (e.g., finance, legal, information technology, human resources) have a pervasive impact on the business and support the business units in the organization's risk program.
9. Certain functions (e.g., internal audit, risk management, compliance) monitor and report on the effectiveness of an organization's risk program to governing bodies and executive management.

### **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 IT milestones and reporting against them, especially for IT transformation.
- Consider post-acquisition reviews, including risks, relevant integration milestones, and ROI analysis to evaluate the reliability of initial acquisition assumptions.
- Have appropriate leaders within the business make a presentation at a board or audit committee meeting to enhance the members' understanding of the business and risks and to evaluate the depth of talent.

**Tools and resources.** The [Risk Oversight](#) section of the [Center for Corporate Governance website](#) provides a number of tools and resources to assist board and audit committee members with risk oversight, such as the [Risk Committee Resource Guide for Boards](#).

## Fraud and internal control over financial reporting

In conjunction with risk oversight, the audit committee should determine that the company has programs and policies in place to prevent and identify fraud. It should work with management to oversee the establishment of appropriate controls and antifraud programs and to take the necessary steps when fraud is detected. The audit committee should also be satisfied that the organization has implemented an appropriate ethics and compliance program and established a complaint hotline. See the *Code of Ethics* and *Complaint Hotline Procedures* sections later in the document for more information.

Audit committee members should be aware of three main areas of fraud:

- Financial statement fraud, which includes intentional misstatements in or omissions from financial statements
- Asset misappropriation, which may include check forgery, theft of money, inventory theft, payroll fraud, or theft of services
- Corruption, which may include schemes such as kickbacks, shell companies, bribes to influence decision-makers, or manipulation of contracts.

Although the audit committee should be concerned with all three types of fraud, financial statement fraud should be their primary focus. Although this type of fraud occurs least frequently, it is often the most costly.

One way the audit committee can help oversee the prevention and detection of financial statement fraud is by monitoring management's assessment of internal control over financial reporting (ICFR). To oversee ICFR successfully, the audit committee must be familiar with the processes and controls management has put in place and understand whether they were designed effectively. The audit committee should work with management, the internal auditors, and the independent auditor to gain the knowledge needed to provide appropriate oversight.

The audit committee should also have an awareness of the U.S. Foreign Corrupt Practices Act (FCPA). The committee should understand the company's responsibilities regarding the FCPA as well as the policies and practices in place related to compliance with the FCPA. The audit committee may also ask management where the highest risks of an infraction exist and what the company's plans are should a violation occur. The committee should be made aware of any actual violations, including management's response.

Leading practices for the oversight of financial reporting and internal controls include the following:

- Understand key controls and reporting risk areas as assessed by financial management, the internal auditors, and the independent auditor.
- Emphasize oversight of corporate taxes, an area where high-risk and high-dollar decisions are made.
- Leverage the value of internal controls beyond compliance.
- Consider levels of authority and responsibility in key areas, including pricing and contracts, acceptance of risk, commitments, and expenditures.

- Understand complex accounting and reporting areas and how management addresses them.
- Understand significant judgments and estimates used by management and their impact on the financial statements, such as fair-value accounting and related assumptions.
- Anticipate and understand how pending financial reporting and regulatory developments may affect the company, particularly its talent needs.

**Tools and resources.** The [Antifraud Programs and Controls](#) and [Internal Control over Financial Reporting](#) sections of the [Center for Corporate Governance website](#) provide resources to assist board and audit committee members.

### Review of earnings press releases and use of non-GAAP financial measures

The audit committee should consider how it will oversee earnings press releases and the financial information and earnings guidance provided to analysts and ratings agencies. It is common for the full audit committee to review each individual earnings release.

The audit committee should confirm that an appropriate legal review has been completed to verify the accuracy and completeness of disclosures, including any obligation to report on trends. This legal review should also consider compliance with the company's policies on forward-looking statements and the completeness of any related disclaimers.

The committee should consider the SEC's rules regarding the use of non-GAAP financial measures in Regulation G and Item 10(e) of Regulation S-K.

**Overview of the requirements.** Under Regulation G, disclosure of any material information containing non-GAAP financial measures must include the most directly comparable GAAP financial measures, as well as a reconciliation of the two.

The NYSE listing standards require the audit committee charter to address the committee's responsibility to discuss earnings press releases and the financial information and guidance provided to analysts and ratings agencies. The commentary to the listing standards indicates that this discussion may be in general terms, and the audit committee may discuss the type of information disclosed and the type of presentation made. The commentary also indicates that the discussion should pay particular attention to any pro forma or adjusted non-GAAP financial information. In addition, the SEC requires registrants to furnish earnings releases or similar announcements on Form 8-K.

### Questions for audit committees to consider

The audit committee should question management on the use of non-GAAP and pro forma financial measures in earnings press releases, filings with the SEC, and other public releases of information. These questions may include:

Does management have a policy for determining non-GAAP or pro forma financial measures?

What non-GAAP or pro forma financial measures are used?

Why are non-GAAP or pro forma financial measures used?

Does management believe the non-GAAP measure provides useful information to investors?

Are the non-GAAP or pro forma measures consistent with those used by peers in the industry?

Are all non-GAAP financial measures reconciled to appropriate GAAP measures?

Are the GAAP financial measures at least equally as prominent as the non-GAAP financial measures?

What is the difference in earnings per share under the GAAP and non-GAAP financial measures?

Did the company meet analysts' expectations for earnings per share using non-GAAP or pro forma financial measures but not using GAAP financial measures?

Has the company received an SEC comment letter regarding non-GAAP financial measures? If so, was it cleared?

Does the company post a net loss when GAAP financial measures are used but net income when non-GAAP or pro forma financial measures are used?

Has management only included non-GAAP adjustments that increase income? If so, are there non-GAAP adjustments that would decrease income that should be highlighted to prevent the financial information from being misleading and to provide appropriate balance?

Can management confirm that no material facts have been omitted or misrepresented?

Are there changes in the non-GAAP or pro forma financial measures used from period to period? If so, do these changes enhance non-GAAP or pro forma adjusted earnings for the current period?

Are non-GAAP or pro forma measures disclosed in the financial statements consistent with those used by management during road shows and conferences?

### Questions for audit committees to consider

When did management last evaluate its approach to providing earnings guidance? Is a change in approach warranted as a result of the current economic environment and other circumstances facing the company?

How can pressures to meet expectations in the short term influence the quality of the company's reported financial results? How could these influence management behavior?

What practices do the company's competitors follow with respect to earnings guidance and other forward-looking information?

What are management's reasons for providing or not providing EPS targets and other types of forward-looking information?

How confident is management in its ability to forecast earnings accurately? Is the disclosure of a range of earnings estimates preferable to a specific target? Should the time frame for which estimates are provided be modified or are more frequent updates necessary?

What are the company's long-term value drivers? What is the specific quantitative and qualitative information—be it financial or nonfinancial in nature—that best reflects these drivers? Is this information provided to investors and analysts on a forward-looking basis?

Has management considered seeking input directly from shareholders regarding the types of forward-looking information they would find meaningful?

Do current circumstances warrant enhanced audit committee review of earnings estimates and other forward-looking information before it is made public?

If the company changes its approach to the provision of earnings guidance and forward-looking information, should the audit committee modify its practices for reviewing that information?

## Code of ethics

A culture that embraces the importance of ethics and compliance can be established only if employees, officers, and directors understand the requirements of the code of ethics.

**Overview of the requirements.** The SEC, the NYSE listing standards, and the NASDAQ listing standards all require a code of ethics or a code of conduct. There are similarities between the requirements, but there are also differences.

**Requirements of the SEC.** The SEC requires registrants to disclose whether they have written codes of ethics that apply to their principal executive officers, principal financial officers, principal accounting officers or controllers, or individuals performing similar functions. If they do not, they must explain why not. Companies must promptly disclose amendments to, and waivers from, codes of ethics relating to any of those people.

The SEC rule defines a code of ethics as a written standard that is reasonably designed to deter wrongdoing and to promote:

- Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships

- Full, fair, accurate, timely, and understandable disclosure in reports and documents that a registrant files with the SEC and in other public communications
- Compliance with applicable laws, rules, and regulations
- The prompt internal reporting of violations to parties identified in the code
- Accountability for adherence to the code.

Companies must include these disclosures in their annual reports filed on Forms 10 K, 10 KSB, 20-F, or 40-F. A company must make its code of ethics available to the public through one of the following methods:

- File a copy of its code of ethics with the SEC as an exhibit to its annual report
- Post the code of ethics on its website, provided that the website address and the intention to provide disclosure in this manner are set forth in its annual report
- Indicate in its annual report that it will provide a copy of its code of ethics to any person, without charge, on request.

U.S. registrants must disclose any changes to, or waivers from, the code of ethics that apply to the CEO or senior financial officers. A company that chooses to provide the disclosure on Form 8-K must do so within four business days after it amends its code of ethics or grants a waiver.

**Overview of the NYSE requirements.** The NYSE listing standards require a code of conduct that covers not only senior financial officers, but all employees. Specifically, the websites of NYSE-listed companies must disclose the code of conduct applicable to employees, directors, and officers. Companies can determine their own policies, but the code must contain the items listed in the table on the following page, only some of which are required by the SEC. Waivers of the code's requirements for executive officers or directors must be disclosed in a Form 8-K within four business days.

### NYSE required items for code of conduct

Treatment of conflicts of interest

Prohibition from taking advantage of personal opportunities arising through the use of corporate property, information, or position

Prohibition from conducting business that competes with that of the company

Treatment of confidential information

Fair behavior in interactions with the company's customers, suppliers, competitors, and employees

Protection and proper use of the company's assets

Compliance with laws, rules, and regulations, including insider-trading laws

Encouragement to report any illegal or unethical behavior

Compliance standards and procedures to facilitate effective operation of the code and to allow prompt and consistent action against violation

A requirement that waivers of the code for executive officers or directors be granted only by the board or a committee of the board and be disclosed to shareholders in a timely manner

**Overview of the NASDAQ requirements.** The NASDAQ listing standards require public disclosure of a code of conduct applicable to all employees, officers, and directors. NASDAQ's criteria for the code of conduct are consistent with the SEC's requirements.

In addition, each code of conduct must provide for prompt and consistent enforcement, protection for individuals who report questionable behavior, clear and objective standards for compliance, and a fair process for determining violations. Any waiver for executive officers or directors must be made only by the board and be disclosed to shareholders promptly, along with the reasons for the waiver. Waivers of the code's requirements

for executive officers or directors must be disclosed in a Form 8-K within four business days (with certain exceptions for foreign private issuers).

Both the NYSE and NASDAQ listing standards permit companies to have more than one code of conduct as long as all directors, officers, and employees are covered by a code.

***Common practices and steps for consideration.*** As highlighted by the U.S. federal sentencing guidelines for organizations, executives and boards of directors have special responsibilities for the oversight and management of ethics and compliance programs, an important component of which is a robust code of ethics or conduct. The board and the audit committee should consider whether the audit committee should be involved in this aspect of corporate governance.

Those responsible for overseeing ethics and compliance should work with management to determine that the company's code of ethics or conduct complies with the applicable requirements. Companies may update the code in response to new issues or situations. When appropriate, legal counsel should be consulted on modifications to the code.

The NYSE listing standards require the audit committee to oversee legal and regulatory compliance, so in many cases the audit committee will be involved in oversight of the code of ethics.

Communication and training are keys to fostering an ethical culture. The code should be available to everyone in the organization, perhaps through inclusion on the company's intranet site and in the orientation manual. Some companies require individuals to sign an annual representation noting that they have read and understand the requirements of the code.

If an employee refuses to sign the code of ethics, committees should encourage companies to use serious discipline, up to and including termination. Communication of disciplinary actions taken in response to code violations is recommended as a means of reassuring employees that violations are being handled seriously.

Board members or members of the committee that oversees compliance should have a thorough understanding of the waiver definition and disclosure requirements. The committee should also consider requiring all board members to acknowledge that they will comply with the code's requirements. Any decision to grant waivers should be considered carefully. A company may want to consider if a requirement to seek preapproval for a conflict with the code obviates the need for a waiver. Those responsible for overseeing ethics and compliance should work with management to establish a process for reporting and addressing violations promptly.

**Tools and resources.** The [Center for Corporate Governance website](#) offers additional information on establishing codes of ethics and robust ethics and compliance programs. These resources include Deloitte's *Suggested Guidelines for Writing a Code of Ethics/Conduct* and *The Tone at the Top: Ten Ways to Measure Effectiveness*. The latter includes a discussion of chief ethics and compliance officers.

### Questions for audit committees to consider

Does the audit committee hear directly from the person who has day-to-day responsibility for compliance matters?

Is the ethics officer independent of the general counsel's office?

Does the ethics officer have an adequate budget to do an effective job?

Does the company regularly and systematically scrutinize the sources of compliance failures and react appropriately?

How does management take action on reports? Is there evidence of employees being disciplined appropriately and consistently?

Does the reporting process keep the audit committee informed of ethics and compliance issues, as well as the actions taken to address them? Is ethics and compliance a regular item on the committee's agenda?

What type of ongoing monitoring and auditing processes are in place to assess the effectiveness of the program?

## Complaint hotline procedures

Companies use hotlines to report a range of compliance issues, including violations of the code of ethics. A thorough, independent, and objective process should be established by management and the audit committee for investigating complaints. Companies use various procedures, but the most common method of receiving tips from inside and outside the organization is through a telephone hotline administered by an internal department or a third party. Telephone hotlines have emerged as a preferred mechanism because they are interactive, allowing a skilled interviewer to elicit details.

**Overview of the requirements.** SEC regulations and the securities market listing standards require the audit committees of listed companies to establish procedures for:

- Receiving, retaining, and addressing complaints regarding accounting, internal accounting controls, or auditing matters, whether from internal or external sources, as well as reporting a range of compliance matters, including code of conduct violations
- The confidential, anonymous submission of employee concerns regarding questionable accounting or auditing matters.

The audit committee should work with management to determine that more than one person in the company is aware of questions or complaints received from third-party vendors, in e-mail, or through other submission vehicles. Responsibility for investigating questions or concerns and reporting back to the audit committee often falls on individuals in the ethics and compliance, internal audit, legal, or risk management departments. Complaints should be categorized and analyzed by root cause, and recommendations should be made to the audit committee on how to reduce the risk of similar complaints in the future.

The audit committee also should be provided with an ongoing analysis of the progress of complaint resolution. Reports should be given to the audit committee regularly in accordance with standing instructions. Some complaints may warrant immediate communication to the audit committee, such as those involving senior management and significant dollar amounts. The audit committee should establish a schedule for reporting to the board of directors.

Complaint hotline systems often include these features:

- Operation by an independent third party
- Staffing by trained interviewers rather than fully automated systems
- A dedicated phone number that is available at all times, along with other reporting means such as fax, the company's website, e-mail, and regular mail
- Multilingual systems and operators.

In addition:

- Complainants should be allowed to call back at a later time, and they should be given the option to file complaints anonymously.
- Complainants must be protected from any retaliation as a result of reporting.
- Protocols should be in place to allow complaints to be channeled to the appropriate individual, and complaints involving senior management should go directly to the audit committee.
- Complaints must be handled in a confidential manner and resolved as quickly as possible.
- Complaint procedures should be well known to all employees, vendors, and other interested parties.

A hotline monitored by an independent third party is preferred. However, if the hotline is administered internally, operators should have specific training on where to direct questions or complaints, including those related to human resources. Whatever the method, audit committee members should work with management to make employees, investors, and others aware of the option of confidential disclosure. Employees can be informed in the code of ethics, the employee handbook, human resources orientation, and ethics training. Instructions for submitting questions or complaints can be posted in company facilities and on intranet sites.

The company website is a natural vehicle for communicating the procedures to individuals outside the organization. As discussed in the code of ethics section, the NYSE listing standards require companies to adopt codes of ethics and disclose them on their websites. NASDAQ-listed companies also must adopt and disclose codes of ethics, and many have chosen to post their codes on their websites. Information on the code of ethics and the complaint hotline often is linked from the home page under a section called “Ethics” or an equivalent. Telephone operators working in customer service and investor relations should be prepared to answer questions on how to submit concerns and complaints regarding financial reporting.

Under the SEC’s whistleblower programs, employees with knowledge of potential securities fraud who report original information to the government or a self-regulatory organization can receive a minimum of 10 percent and as much as 30 percent of monetary sanctions if the enforcement action results in fines of at least \$1 million.

Whistleblowers are not required to report issues first through internal company channels; however, those choosing to do so are still eligible for the reward if the company reports the problem to the government or if the whistleblower does so within 120 days of notifying the company.

It is important for the audit committee to work with management and internal audit to understand:

- Opportunities to enhance internal whistleblowing systems
- The potential advantages of implementing timely internal whistleblower cash awards to sustain and encourage internal whistleblowing
- The potential value of transaction monitoring tools to help promptly identify potential securities fraud issues such as bribery or financial statement fraud.

**Tools and resources.** The [Fraud Resources section of the Association of Certified Fraud Examiners’ website](#), at [www.acfe.com](http://www.acfe.com), provides many articles on whistleblower hotlines. Deloitte’s resources to address ethics and compliance issues are discussed in the [Code of Ethics](#) section of this document as well as in the [Ethics and Compliance](#) and [Antifraud Programs and Controls](#) sections of the [Center for Corporate Governance website](#).

Section Four

# Interaction with the independent auditor

Auditor independence

Fee disclosure

Evaluation of the independent auditor

## Interaction with the independent auditor

Audit committees of listed companies are directly responsible for the appointment, compensation, and oversight of the independent auditor, including the resolution of any disagreements with management. It is optimal for the audit committee, management, the internal auditors, and the independent auditor to work together in a spirit of mutual respect and cooperation.

Leading practices for the audit committee's relationship with the independent auditor include:

- Exercise ownership of the relationship with the independent auditor
- Get to know the lead partners and meet periodically with specialists (e.g., tax, IT, fair value)
- Establish expectations regarding the nature and method of communication, as well as the exchange of insights
- Engage in regular dialogue outside of scheduled meetings
- Set an annual agenda with the independent auditor
- Focus on independence, including a preapproval process
- Provide formal evaluations and regular feedback.

Private sessions with the independent auditor are a way to maintain open communication and identify concerns. Periodic private sessions are required for NYSE-listed companies. The audit committee and the independent auditor typically meet at least quarterly and engage in thorough discussion.

The audit committee should have a process for overseeing management's resolution of significant issues raised by the independent auditor.

**Overview of the requirements.** The following is a summary of communications required by the PCAOB, the SEC, and the NYSE and NASDAQ listing standards.

**PCAOB.** Auditing Standard No. 16 (AS 16), *Communications with Audit Committees*, and amendments to other PCAOB standards are effective for public company audits of fiscal periods beginning after December 15, 2012. Refer to the following table for a summary of the communication requirements outlined in AS 16.

Additional information about the requirements of AS 16 follows the table.

### Communications required by AS 16

Significant issues discussed with management before the auditor's appointment or retention

Establishing an understanding of the terms of the audit ➤

Obtaining information relevant to the audit ➤

Overview of the audit strategy, timing of the audit, and significant risks +

Results of the audit including: ➤

- Significant accounting policies and practices
- Critical accounting policies and practices
- Critical accounting estimates
- Significant unusual transactions

Auditor's evaluation of the quality of the company's financial reporting ➤

Other information in documents containing audited financial statements

Difficult or contentious matters about which the auditor consulted +

Management consultations with other accountants

Going-concern matters +

Uncorrected and corrected misstatements

Material written communications

Departure from the auditor's standard report +

Disagreements with management

Difficulties encountered in performing the audit

Other matters +

### Communications required by other PCAOB standards or rules

Material weaknesses and significant deficiencies in internal control

Representations of management

Fraud and illegal acts

Communications in connection with interim reviews

Preapproval of services

Independence matters

Unless otherwise specified, the auditor should communicate to the audit committee orally or in writing in a timely manner and prior to issuance of the auditor's report. Under AS 16, the auditor is required to communicate with the audit committee about the following:

- Significant issues discussed with management prior to the initial appointment or retention of the auditor
- An understanding of the terms of the audit engagement—outlined annually in an engagement letter—including the objective of the audit and the responsibilities of the auditor and management
- Whether the audit committee is aware of matters relevant to the audit, including, but not limited to, violations of laws or regulations
- An overview of the overall audit strategy, timing, and significant risks, including (i) the nature and extent of specialized skills necessary to perform planned audit procedures, (ii) the extent to which the independent auditor plans to rely on work performed by the company's internal audit function or others in the audits of the financial statements and internal control over financial reporting, (iii) the names, locations, and anticipated responsibilities of any firm or personnel performing audit work in the current period but not employed by the auditor, (iv) the auditor's rationale for serving as principal auditor if significant parts of the work are performed by others, and (v) any significant changes to the original strategy or significant risks and the reasons for such changes

+ New requirement\*   ➤ Expanded requirement\*

\*As compared to previous requirements

- Significant accounting policies and practices, including (i) management's initial selection of, or changes in, significant accounting policies or the application of such policies in the current period, and (ii) the effect on financial statements or disclosures of significant accounting policies in controversial areas or areas for which there is a lack of authoritative guidance or consensus, or diversity in practice
- All critical accounting policies and practices to be used, including (i) the reasons certain policies and practices are considered critical, and (ii) how current and anticipated events might affect the determination of whether certain policies and practices are considered critical
- Critical accounting estimates, including (i) a description of the process management used to develop critical accounting estimates, (ii) management's significant assumptions used in critical accounting estimates that have a high degree of subjectivity, (iii) any significant changes management made to the processes used to develop critical accounting estimates or significant assumptions, a description of management's reasons for the changes, and the effects of the changes on the financial statements
- Significant unusual transactions, including (i) significant transactions that are outside the normal course of business for the company or that otherwise appear to be unusual due to their timing, size, or nature, and (ii) the policies and practices management used to account for significant unusual transactions
- The auditor's evaluation of the quality of the company's financial reporting, including (i) qualitative aspects of significant accounting policies and practices, (ii) assessment of critical accounting policies and practices, (iii) conclusions regarding critical accounting estimates, (iv) the business rationale for significant unusual transactions, (v) financial statement presentation, including the related disclosures, (vi) management's anticipated application of new accounting pronouncements that might have significant effects in future periods, and (vii) alternative accounting treatments
- The auditor's responsibility, including any related procedures performed and the results of such procedures under PCAOB rules and standards when other information is presented in documents containing audited financial statements
- Matters that are difficult or contentious for which the auditor consulted outside the engagement team and that the auditor reasonably determined are relevant to the audit committee's oversight of the financial reporting process
- Management's consultation with other accountants about significant auditing or accounting matters when the auditor has identified a concern regarding such matters
- Evaluation of the company's ability to continue as a going concern, including (i) any conditions and events that the auditor has identified that indicate substantial doubt about the company's ability to continue as a going concern for a reasonable period of time, (ii) the auditor's conclusion about management's plans to alleviate substantial doubt about the company's ability to continue as a going concern, (iii) the effects, if any, on the financial statements and related disclosure, as well as the auditor's report, if substantial doubt remains about the company's ability to continue as a going concern for a reasonable period of time

- A schedule of uncorrected misstatements related to accounts and disclosures, as well as those corrected misstatements (unless clearly trivial) that related to accounts and disclosures that might not have been detected except through the auditing procedures performed and the implication of these misstatements on the company's financial reporting
- Other material written communications between the auditor and management
- Departures from the auditor's standard report, including (i) the reasons for modifying and the wording to be used when the auditor expects to modify the opinion, and (ii) the reasons for explanatory language or paragraph and the wording to be used when the auditor expects to include explanatory language or an explanatory paragraph
- Any disagreements with management about matters, whether or not satisfactorily resolved, that individually or in the aggregate could be significant to the company's financial statements or the auditor's report
- Any significant difficulties encountered during the audit, including, but not limited to, (i) significant delays by management, the unavailability of company personnel, or an unwillingness by management to provide information needed for the auditor to perform his or her audit procedures, (ii) an unreasonably brief time within which to complete the audit, (iii) unexpected extensive effort required by the auditor to obtain sufficient appropriate audit evidence, (iv) unreasonable management restrictions encountered by the auditor on the conduct of the audit,

and (v) management's unwillingness to make or extend its assessment of the company's ability to continue as a going concern when requested by the auditor

- Other matters arising from the audit that are significant to the oversight of the company's financial reporting process, including complaints or concerns regarding accounting or auditing matters that have come to the auditor's attention during the audit and the results of the auditor's procedures regarding such matters.

PCAOB Ethics and Independence Rule 3526, *Communication with Audit Committees Concerning Independence*, requires the independent auditor to provide, at least annually, a formal written statement delineating all relationships between the independent auditor and the company, including individuals in financial reporting oversight roles at the company, that reasonably can be thought to bear on independence. The company and the auditor should engage in an active dialogue with respect to any disclosed relationships or services that may affect the objectivity and independence of the auditor.

Standards of the PCAOB (including AU 380, AU 325, or AS 5, as applicable) require the independent auditor to communicate all material weaknesses and significant deficiencies identified during the audit to the audit committee, in writing. In addition, if the independent auditor concludes that the audit committee's oversight of the company's external financial reporting and internal control over financial reporting is ineffective, the auditor is required to inform the board of directors.

**SEC.** Regulation S-X, Rule 2-07, *Communication with Audit Committees*, requires the independent auditor to communicate the following to the audit committee:

- Critical accounting policies and practices used by the issuer
- Alternative accounting treatments within U.S. GAAP for accounting policies and practices related to material items that have been discussed with management during the current audit period, including the ramifications of the use of such alternative disclosures and treatments and the treatment preferred by the independent auditor
- Material written communications between the independent auditor and management of the issuer
- All nonaudit services provided to any entity in an investment company complex if the audit client is an investment company, as defined in 210.2-01(f)(14), that were not preapproved by the registered investment company's audit committee pursuant to 210.2-01(c)(7).

The SEC stated in its rule release that it expects these discussions to occur prior to filing Form 10-Q or Form 10-K.

SEC rules also require companies to include an audit committee report in their proxy statements. In the report, the audit committee must state whether it has:

- Reviewed and discussed the audited financial statements with management
- Discussed with the independent auditor all matters required under applicable auditing standards
- Received required independence disclosures from the independent auditor.

Based on this review and discussion, the report must also include a statement of whether the audit committee recommended to the board that the audited financial statements be included in the annual report to be filed with the SEC.

**Tools and resources.** The AICPA's [Audit Committee Toolkit](#) includes "Discussions to Expect from the Independent Auditor."

## Required communications

### NYSE

The NYSE listing standards require the audit committee to communicate with the independent auditor in the following ways:

- Meet to review and discuss with the independent auditor the company's annual audited financial statements and quarterly financial statements, including disclosures in management's discussion and analysis
- Periodically, meet separately with the independent auditor, management, and the internal auditors
- Obtain a formal written communication from the independent auditor regarding independence and other matters annually
- Review with the independent auditor any audit problems or difficulties and management's response
- Set clear hiring policies for employees or former employees of the company's independent auditor.

### NASDAQ

The NASDAQ listing standards require the audit committees of listed companies to obtain a formal written statement from the independent auditor, consistent with PCAOB Ethics and Independence Rule 3526, *Communication with Audit Committees Concerning Independence*.

## Auditor independence

The SEC and PCAOB rules govern the independence of accountants who audit or review financial statements and prepare attestation reports filed with the SEC. The rules recognize the critical role of audit committees in financial reporting and their unique position in monitoring auditor independence.

The SEC independence rule addresses the following issues related to registrants:

- Relationships between the auditor and its audit client arising from:
  - Financial interests
  - Employment
  - Business dealings other than the audit and nonaudit services
- Nonaudit services provided by auditors
- Contingent fees and commissions
- Partner rotation
- The audit committee's administration of the audit engagement
- Compensation of audit partners.

**Financial interests.** The rule states that independence is impaired if the audit firm or certain of its people have a direct or material indirect financial interest in an audit client. Examples of prohibited financial interests include an investment in the audit client's debt or equity securities, loans, deposits not fully insured by the FDIC, broker-dealer account balances not fully insured under SIPC, and certain individual insurance products.

**Employment relationships.** The rule states that independence is impaired if a current partner, principal, shareholder, or professional employee of the independent auditor has an employment relationship with, or serves as a member of the board of directors or similar management or governing body of, the audit client. Former partners, principals, shareholders, or professional employees of the independent auditor cannot be employed in an accounting role or financial reporting oversight role—one who exercises more than minimal influence over the contents of accounting records or prepares them—at an audit client unless they are fully separated from the independent auditor, financially and otherwise. Even if this separation is achieved, former members of the audit engagement team for an issuer cannot take a financial reporting oversight role for the issuer before completion of one annual audit subsequent to the engagement period when the individual was a part of the engagement team. Employment restrictions also apply to certain close family members of the independent auditor’s personnel.

**Business relationships.** The rule prohibits an independent auditor from having a direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity, such as an audit client’s officers, directors, or substantial stockholders. This prohibition does not preclude the independent auditor from providing permissible services to the audit client or purchasing goods or services from the audit client as a consumer in the ordinary course of business.

**Nonaudit services provided by auditors.** The rule sets forth 10 categories of services that impair the independent auditor’s independence if provided to an audit client. The rule permits an auditor to provide other nonaudit services to an issuer if the services are preapproved by the audit committee; however, the nonaudit fee does not have to be approved by the audit committee. Permissible nonaudit services include due diligence for mergers and acquisitions, internal control reviews, and tax services that are not prohibited by the PCAOB.

In certain circumstances, the independent auditor may provide bookkeeping, design and implementation of financial information systems, appraisal or valuation services, actuarial services, and internal audit outsourcing to a non-client affiliate of an audit client if “it is reasonable to conclude that the results of these services will not be subject to auditing procedures during an audit of the audit client’s financial statements.” This is referred to as the “not-subject-to-audit” exception.

Prohibited services:

1. Bookkeeping or other services related to the accounting records or financial statements of the audit client
2. Design and implementation of financial information systems
3. Appraisal or valuation services, fairness opinions, or contribution-in-kind reports
4. Actuarial services
5. Internal audit outsourcing
6. Management functions
7. Human resources

8. Broker-dealer, investment advisory, or investment banking services
9. Legal services
10. Expert services

In addition to the SEC's 10 categories of prohibited services, the PCAOB also has discretion to prohibit any other service that it determines, by regulation, to be impermissible. To date, the PCAOB has issued rules prohibiting the independent auditor from:

- Providing a service or product to an audit client for a contingent fee or commission
- Marketing, planning, or opining in favor of the tax treatment of a confidential or aggressive tax transaction
- Providing tax services to persons in a financial reporting oversight role for an audit client.

**Partner rotation.** The SEC's rule requires the lead audit and engagement quality review partners to rotate after five years, at which time they are subject to a five-year "time-out" period. Audit partners who are significantly involved with senior management or the audit committee or who are responsible for decisions on accounting matters that affect the financial statements, as well as advisory partners, must rotate after seven years and are subject to a two-year time-out period. This includes audit partners who serve as the lead partner for significant subsidiaries. Significant subsidiaries are defined as those accounting for greater than 20 percent of an issuer's revenues or assets. Specialty partners, such as tax partners, are not required to rotate.

**The audit committee's administration of the audit engagement (preapproval).** The audit committee must preapprove permissible audit and nonaudit services to be provided to the issuer and its subsidiaries. Preapproval can be obtained directly or based on policies and procedures that are detailed as to the type of service. These policies and procedures do not circumvent the need to inform the audit committee of the service, and the committee cannot delegate its preapproval responsibilities to management. It can, however, delegate preapprovals to one or more members of the committee if the preapprovals are reported at the next scheduled meeting of the full committee.

Further, the PCAOB rules provide that an audit firm seeking preapproval of tax services or nonaudit services related to internal control over financial reporting must:

1. Describe, in writing, the scope of the service. For tax services, the audit firm must describe, in writing, (i) the fee structure for the engagement, any side letter or other amendment to the engagement letter, or any other agreement between the firm and the audit client relating to the service; and (ii) any compensation arrangement or other agreement between the registered public accounting firm or an affiliate and any person other than the audit client with respect to promoting, marketing, or recommending a transaction covered by the service
2. Discuss with the audit committee of the issuer the potential effects of the services on the independence of the firm
3. Document the substance of its discussion with the audit committee of the issuer.

**Compensation of audit partners.** Under the SEC’s rule, an auditor is not independent if, at any point during the audit and professional engagement period, any audit partner other than a specialty partner receives compensation from selling engagements to provide the audit client with any services other than audit, review, or attest services.

For the purpose of this restriction, the SEC defines the term “audit partner” as the lead and concurring partners and other partners on the engagement team who have responsibility for making decisions on significant auditing, accounting, and reporting matters that affect the financial statements or who maintain regular contact with management or the audit committee. This includes all audit partners serving the client at the issuer or parent, with the exception of specialty partners, as well as the lead partner at subsidiaries whose assets or revenues constitute at least 20 percent of the consolidated assets or revenues.

**Tools and resources.** View the [Interaction with the Independent Auditor section](#) of the [Center for Corporate Governance website](#) for further information.

## Fee disclosure

The SEC’s rule that implemented the Sarbanes-Oxley Act expanded on the requirements to disclose fees paid to the auditor, and many companies have opted to provide even more information. For instance, many companies subtotal the audit and audit-related fees so shareholders can easily quantify the portion of services that are audit and audit-related in nature.

Because certain institutional investors and investor advisers, such as RiskMetrics Group, have guidelines for proxy-vote recommendations, many companies disclose not only the nature of services in the fee categories but also the amounts associated with specific services in a particular category. For example, it is not uncommon for companies to bifurcate the disclosed tax fees into one amount for tax compliance services and another for tax planning services. Issuers should consult with legal counsel to determine the content of the fee disclosure.

### **Overview of the requirements.**

1. **Audit fees** are fees for services that normally would be provided in connection with statutory and regulatory filings or engagements, including the audit of internal control over financial reporting. This category also may include services that only the independent auditor reasonably can provide, such as comfort letters, statutory audits, attest services, consents, and assistance with documents filed with the SEC.

Audit fees may include certain services provided by specialists who assist in the audit, such as tax specialists needed to audit the tax provision or valuation specialists needed to audit a fair-value assertion; certain accounting consultations in connection with the audit; and similar items that are not billed as audit services and that only the independent auditor reasonably can provide.

2. **Audit-related fees** are for assurance and related services that are performed by the independent auditor, such as audits of employee benefit plans, due diligence related to mergers and acquisitions, accounting consultations and audits in connection with acquisitions, internal control reviews (not the audit of internal control over financial reporting, which is part of audit fees), attest services that are not required by statute or regulation, and consultation concerning financial accounting and reporting standards (to the extent that such consultation is not necessary to complete the GAAS audit).

3. **Tax fees** include all tax services performed except those related to the audit (such as review of the tax provision, which would be included in audit fees). Typically, tax fees cover tax compliance, tax planning, and tax advice. Tax compliance generally involves preparation of original and amended tax returns, refund claims, and tax-payment planning services. Tax planning and tax advice encompass a diverse range of services, including assistance with tax audits and appeals, tax advice related to mergers and acquisitions, employee benefit plans, and requests for rulings or technical advice from tax authorities.
4. **All other fees** include all fees paid to the independent auditor for services other than audit, audit-related, or tax services.

The SEC rule requires disclosure of fees paid to the independent auditor for the current year and the prior year, as well as a description of the services included in all categories, other than for audit fees, for both years. The audit committee's preapproval policies and procedures must be disclosed in a detailed description or by including the policy itself, along with disclosure of any services that were initially missed and later approved under a de minimis exception present in the SEC's rule. Disclosures are required in the issuer's annual report as well as the proxy statement, but companies are allowed to incorporate the information into their Form 10-K from their proxy statement.

## Evaluation of the independent auditor

Because there is no formal guidance regarding the evaluation of the independent auditor and as needs and preferences vary by company and audit committee, practices for evaluating the independent auditor range from highly formalized processes with extensive documentation to more informal processes. Factors the audit committee may consider in developing an evaluation process include:

- **Frequency and timing of the evaluation.** Many audit committees perform the evaluation annually, immediately following the issuance of the Form 10-K.
- **Parties involved in the assessment.** Although the SEC does not explicitly require the audit committee to periodically evaluate the independent auditor, many conduct some form of evaluation to make decisions on auditor appointment and retention. As noted previously, the SEC established the audit committee's responsibility for the appointment, compensation, and oversight of the independent auditor. However, it may not be practical for the audit committee to oversee and coordinate the entire evaluation. In many instances, the audit committee delegates the coordination responsibility to the internal audit department or another group in the company. The party responsible for coordinating the evaluation should obtain information not only from the audit committee, but from senior financial management and the internal auditors. Depending on the size and structure of the company, it may be appropriate to obtain input from the management of significant operating locations or business units.
- **Form and nature of the assessment.** Some independent auditors have assessment questionnaires for evaluating client service. Audit committees can use these questionnaires, tailor them to fit their needs, or create their own. The assessment can be done by having the relevant parties complete the questionnaire in writing or by holding interviews. They may also have a discussion about the experience the audit committee and others at the company have had in working with the independent auditor.
- **Assessment criteria.** The criteria for evaluating the independent auditor vary. Common criteria specific to the engagement team include technical competence; industry knowledge; frequency and quality of communication; cohesiveness as a team; demonstrated independence, objectivity, and professional skepticism; and the level of support provided to the audit committee in fulfilling its responsibilities. Audit committees may consider information about the characteristics of the audit firm itself, such as size, financial strength and stability, presence in key markets, approach to professional development, technological capabilities, nature of the audit approach, quality of thought leadership, and eminence in the marketplace. Information about the results of the PCAOB inspection process and peer reviews may also be considered in the evaluation.

**Overview of the requirements.** The NYSE listing standards require the audit committee to review a report by the independent auditor describing quality control, results of investigations, and independence. The commentary accompanying this listing standard states that after reviewing the report and the independent auditor’s work throughout the year, the audit committee will be in a position to evaluate the auditor’s qualifications, performance, and independence.

The commentary also specifies that the “evaluation should include the review and evaluation of the lead partner of the independent auditor,” and “should take into account the opinions of management and the company’s internal auditors (or other personnel responsible for the internal audit function).”

**Tools and resources.** There are various tools and resources available to assist the audit committee in its evaluation of the independent auditor.

The AICPA’s *Audit Committee Toolkit* includes “Evaluating the Independent Auditor: Questions to Consider,” which provides examples of questions for the audit committee, the CFO, the internal auditors, and the independent auditor.

In addition, the Center for Audit Quality published an assessment tool, *Audit Committee Annual Evaluation of the External Auditor*, which includes questions that an audit committee may want to consider in its evaluation of the independent auditor, including the audit team, lead partner, and engagement quality reviewer.

The PCAOB issued *Information for Audit Committees about the PCAOB Inspection Process*, which is intended to assist audit committees in better understanding the PCAOB’s inspection process and gathering information from their audit firms about inspections.

Section Five

# Education and evaluation

Board education

Audit committee performance evaluation

## Section Five

### Leading practices

- Address board education in the company's corporate governance guidelines to be consistent with NYSE listing standards
- Provide orientation of new members that involves company executives, internal audit, and the independent auditor
- Offer ongoing one-on-one or committee-level education opportunities
- Consider offering continuing education in specialized or regulated industry matters, reporting, operations, and related topics

### Board education

The NYSE listing standards require board education to be addressed in the company's corporate governance guidelines. Boards and audit committees should use a needs-based approach to determine the specific topics in a continuing education program.

With the enhanced focus on the responsibilities of boards and audit committees, continuing education for directors is an area of increasing importance. There are many options; for instance, public forums on corporate governance are offered by many professional services firms, universities, and not-for-profit organizations. Benefits include the opportunity to meet with peers and share experiences, and these programs can be invaluable for gaining knowledge from experts on trends in corporate governance. These forums often feature speakers who would not be available otherwise. However, boards should be careful not to rely completely on public programs designed for a broad audience, because they may not address the dynamics of a specific company and its industry.

An increasingly popular option is a customized program of continuing education focusing on topics such as roles and responsibilities, risk oversight, industry expertise, and financial literacy. Customized courses can address subjects relevant to the company's needs and incorporate company-specific policies, processes, and objectives.

When designing a program of continuing education, the board should identify risks and complex issues facing the organization. Directors can then evaluate their knowledge in these areas. This self-assessment can help the board gain a better picture of the issues it should include in the program. Depending on the organization's size and complexity, the board may want to enlist the internal auditors or outside consultants in the self-assessment process.

For the audit committee, the focus is more specific, centered on financial reporting and accounting issues such as revenue recognition, pensions and other post-employment benefits, financial instruments, critical accounting policies, and internal controls. The audit committee may use Deloitte's self-assessment tools, which are available on the [Center for Corporate Governance website](#), to identify specific areas for educational focus.

Once a curriculum is set, the board, the audit committee, and management can assess the resources available to create and deliver the program. The program could be developed using a mix of individuals—some with company knowledge and others with an external perspective.

In addition to continuing education, the company should consider orientation programs for new directors and audit committee members. Materials may include information on the company's history and operations, corporate governance, recent SEC filings, industry trends, accounting policies and practices, company policies and the code of ethics, and major business and financial risks.

Audit committees also benefit from periodically inviting subject-matter specialists to participate in audit committee meetings to enhance the committee's knowledge and effectiveness. For example, specialists in international tax, governance, or a particular industry could provide valuable insight in addressing risks or new requirements. Independent auditors or outside consultants can assist in identifying appropriate specialists.

**Tools and resources.** For additional information, visit the [Board Evaluations, Education, and Development section](#) of the [Center for Corporate Governance website](#).

## Audit committee performance evaluation

**Overview of the requirements.** The NYSE listing standards require audit committees to perform an annual performance evaluation, and this responsibility must be set forth in the audit committee's charter. The SEC does not require audit committees to assess their performance, but the legislation itself may be the strongest argument for a robust evaluation process.

Performance assessments also provide information that the audit committee can use to improve processes. This is important because the independent auditor must consider the effectiveness of the audit committee's oversight of financial reporting when evaluating the control environment as part of its internal control over financial reporting audit procedures. The following factors are often considered when evaluating the audit committee's effectiveness:

- Independence of the audit committee members from management
- Clarity with which the audit committee's responsibilities are articulated and the degree to which they are understood by management and the audit committee
- Interaction of the audit committee and the independent auditor, the internal auditors, and senior financial executives
- Whether the audit committee raises the right questions with management and the independent auditor, including questions that indicate the audit committee's understanding of critical accounting policies and judgments and that challenge management's judgments and conclusions
- Whether the audit committee has been responsive to issues raised by the independent auditor.

Because there are no specific guidelines for assessing an audit committee's performance, members and directors have the benefit and the burden of collaborating on an appropriate process. When advisable, this can be done in consultation with legal counsel.

There are several considerations in shaping the assessment process. First, there are various parties that may lead the assessment: the audit committee; the entire board or its nominating/governance committee; or the internal auditors. Some audit committees have found it useful to engage an objective third party to assist with the evaluation process. A combination of these may prove optimal. For example, a committee may choose to engage an external adviser every two or three years, and facilitate the process internally in the other years.

The format of the evaluation is another consideration. In the case of a self-assessment, audit committee members may complete a questionnaire collectively or individually. If the internal auditors, the board, or management conducts the assessment, the format may consist of evaluation forms, interviews, or both. The party leading the evaluation may consider soliciting information from individuals who have significant interaction with the audit committee. The committee may want to consider changing the process periodically to keep it fresh.

Documentation is another significant concern, and the advice of corporate counsel is important in this matter. Regardless of the level of documentation in the evaluation process, the audit committee should identify and address opportunities for improvement.

Developing and executing a plan for improvement is the ultimate objective of the assessment. A performance evaluation may highlight the need to examine issues such as the audit committee's composition and qualifications, information related to key financial reporting areas, members' understanding of complex accounting and financial reporting issues, and meeting agendas.

A well-crafted performance assessment process can provide a number of benefits to the audit committee, including:

- Prioritizing the audit committee agendas and meeting structure to focus on the most critical issues
- Shifting compliance oversight into the time between live meetings
- Considering the committee's composition in the context of current and future financial reporting challenges
- Revisiting the timing, level of detail, and quality of materials provided by management
- Identifying topics for continuing education.

**Tools and resources.** Deloitte's [Center for Corporate Governance website](#) has a [Performance Evaluations](#) section for audit committees. There are several tools and resources, including a questionnaire that can be used for self-assessment. The AICPA's [Audit Committee Toolkit](#) includes "Conducting an Audit Committee Self-Evaluation: Guidelines and Questions," which also provides self-evaluation guidance for audit committees.

Section Six

# Additional responsibilities

## Section Six

### Executive (private) sessions

- Schedule regular sessions with the internal auditors, the independent auditor, and management
- Provide clear objectives and expectations for each meeting
- Prepare specific topics and questions
- Understand the response and resolution to each issue raised

For a list of suggested questions for management, the independent auditor, and the internal auditors during executive sessions, refer to the AICPA's "[Conducting an Audit Committee Executive Session: Guidelines and Questions.](#)"

The NYSE and NASDAQ listing standards include responsibilities for audit committee members beyond those discussed previously. The SEC also grants additional authority to the audit committee.

The NYSE, NASDAQ, and the SEC all authorize the audit committee to engage and compensate independent counsel and advisers. In addition, the NYSE requires the audit committee to periodically meet privately with management, the independent auditor, and the internal auditors.

The audit committee may use the same counsel and advisers as management, but circumstances may warrant otherwise. Lawyers are the outside advisers most often engaged by audit committees. The primary reasons audit committees engage counsel are legal proceedings, corporate governance issues, whistleblower inquiries, fraud concerns, and SEC matters. The services may be investigative, or they may be used to identify potential process improvements. Audit committees may also consider engaging outside advisers to assist with their annual performance evaluations and continuing education.

The AICPA's *Audit Committee Toolkit* includes "Engaging Independent Counsel and Other Advisers," which can help audit committees in this task.

Another leading practice is to conduct separate executive sessions at least quarterly, absent members of management. All sessions should be scheduled on the calendar of activities with the flexibility to hold additional meetings.

**Review of related-party transactions.** The NASDAQ and NYSE listing standards each contemplate that the audit committee of a listed company, or another independent body of the board, will review all related-party transactions.

### Questions for audit committees to consider

The following questions may help determine that the audit committee has an efficient process for fulfilling its responsibility for approving related-party transactions:

- What process will the committee follow in reviewing and approving related-party transactions? Is this process documented?
- Will special meetings be called as potential transactions arise?
- What information does the committee need to make an informed judgment about the appropriateness of a transaction?
- Who will be responsible for presenting this information?

For each transaction brought for approval, the committee may consider asking:

- What are the business reasons for the transaction? Are these reasons in line with the company's overall strategy and objectives?
- How will investors view the transaction when it is disclosed?
- Which insiders will benefit from the transaction and in what way?
- What impact will the transaction have on the financial statements?
- Are any outside advisers needed to help understand the implications of the transaction?

**Other review requirements.** NYSE listing standards require the audit committee to review certain other items. The first involves major issues regarding accounting principles and the presentation of the financial statements. These include any significant changes in the company's selection or application of accounting principles, the adequacy of internal controls, and any special audit steps adopted in response to what the NYSE terms "material control deficiencies." These discussions with management can be held during the review of the quarterly financial statements to be filed with the SEC.

Discussions regarding internal controls and special audit steps to address significant deficiencies also may be guided by SEC certification requirements for the principal executive officer and the principal financial officer in Item 307 of Regulation S-K.

The second requirement is to review management's analyses of significant issues in financial reporting and judgments made in preparing the financial statements, including the effects of alternative GAAP methods. This discussion can be held during the review of the quarterly financial statements. The audit committee may consider having management identify recurring issues related to financial reporting, including significant accounting policies, estimates, and judgments. A standard quarterly analysis may be useful for these meetings, and management should tailor the analysis to include new or unusual items that arose during the quarter. Because Regulation S-X, Rule 2-07 requires the independent auditor to discuss the effects of alternative GAAP methods on the financial statements, the information presented by management should be corroborated by the independent auditor.

The final requirement is to review the effect of regulatory and accounting initiatives and off-balance-sheet structures on the financial statements. Management and the audit committee should discuss pending technical and regulatory matters that could affect the financial statements. The audit committee should be updated on management's plans to implement new technical or regulatory guidelines. The review of off-balance-sheet structures should be a recurring item on the agenda, and may be done as part of the committee's review of management's discussion and analysis in the annual and quarterly reports. The frequency will depend on the company's operations and inclination to use those structures. The audit committee should consider reviewing off-balance-sheet structures, or at least material ones, before they are executed.

# Appendices

Appendix A	Sample audit committee charter
Appendix B	Planning tool: Audit committee calendar of activities
Appendix C	Financial literacy self-assessment tool
Appendix D	Audit committee performance evaluation

# Sample audit committee charter

*This sample audit committee charter is based on a review of selected Fortune 1000 company charters, as well as the requirements of the SEC and the NYSE and NASDAQ corporate-governance listing standards. Deloitte & Touche LLP does not accept any responsibility for any errors this publication may contain, whether caused by negligence or otherwise, or for any losses, however caused, sustained by any person that relies on it. The information presented can and will change; we are under no obligation to update such information. Deloitte & Touche LLP makes no representations as to the sufficiency of these tools for your purposes, and, by providing them, we are not rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. These tools should not be viewed as a substitute for such professional advice or services, nor should they be used as a basis for any decision that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional adviser. Deloitte & Touche LLP does not assume any obligations as a result of your access to or use of these tools.*

*This template is designed for U.S. public companies; exceptions to the requirements noted below may apply for certain issuers, including investment companies, small-business issuers, and foreign private issuers. Many of the items presented here are not applicable to voluntary filers. All companies should consult with legal counsel regarding the applicability and implementation of the various requirements identified.*

## Audit committee of the board of directors—charter

### I. Purpose and authority

The audit committee is established by and among the board of directors for the primary purpose of assisting the board in:

- Overseeing the integrity of the company's financial statements [NYSE Corporate Governance Rule 303A.7(c)(i)(A)] and the company's accounting and financial reporting processes and financial statement audits [NASDAQ Corporate Governance Rule 5605(c)(1)(c)].
- Overseeing the company's compliance with legal and regulatory requirements [NYSE Corporate Governance Rule 303A.7(c)(i)(A)].
- Overseeing the registered public accounting firm's (independent auditor's) qualifications and independence [NYSE Corporate Governance Rule 303A.7(c)(i)(A) and NASDAQ Corporate Governance Rule 5605(c)(1)(b)].
- Overseeing the performance of the company's independent auditor [NYSE Corporate Governance Rule 303A.7(c)(i)(A) and NASDAQ Corporate Governance Rule 5605(c)(1)(b)] and internal audit function [NYSE Corporate Governance Rule 303A.7(c)(i)(A)].
- Overseeing the company's systems of disclosure controls and procedures, internal controls over financial reporting, and compliance with ethical standards adopted by the company.

Consistent with this function, the audit committee should encourage continuous improvement of, and should foster adherence to, the company's policies, procedures, and practices at all levels. The audit committee should also provide for open communication among the independent auditor, financial and senior management, the internal audit function, and the board of directors.

The audit committee has the authority to conduct investigations into any matters within its scope of responsibility and obtain advice and assistance from outside legal, accounting, or other advisers, as necessary, to perform its duties and responsibilities [Rule 10A of the Exchange Act, NYSE Corporate Governance Rule 303A.6, and NASDAQ Corporate Governance Rule 5605(c)(3)].

In carrying out its duties and responsibilities, the audit committee shall also have the authority to meet with and seek any information it requires from employees, officers, directors, or external parties.

The company will provide appropriate funding, as determined by the audit committee, for compensation to the independent auditor, to any advisers that the audit committee chooses to engage, and for payment of ordinary administrative expenses of the audit committee that are necessary or appropriate in carrying out its duties. [Rule 10A of the Exchange Act, NYSE Corporate Governance Rule 303A.6, and NASDAQ Corporate Governance Rule 5605(c)(3)].

The audit committee will primarily fulfill its responsibilities by carrying out the activities enumerated in Section III of this charter.

## II. Composition and meetings<sup>1</sup>

The audit committee will comprise three or more directors as determined by the board [NYSE Corporate Governance Rules 303A.6 and 7(a) and 7(b), and NASDAQ Corporate Governance Rule 5605(c)(2)(A)].

Each audit committee member will meet the applicable standards of independence and the determination of independence will be made by the board [SEC Rule 10A of the Exchange Act, NYSE Corporate Governance Rules 303A.6 and 7(a) and 7(b), and NASDAQ Corporate Governance Rule 5605(c)(2)(A)].

All members of the committee must comply with all financial-literacy requirements of the securities exchange(s) on which the company is listed. To help meet these requirements, the audit committee will provide its members with annual continuing education opportunities in financial reporting and other areas relevant to the audit committee.<sup>2</sup> At least one member will qualify as an “audit committee financial expert” as defined by the SEC and determined by the board [Item 407(d)(5) of Regulation S-K].<sup>3</sup>

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1 Consideration also should be given to the amount of time members of the audit committee can devote to the role. While there are currently no regulations limiting the number of public-company audit committees on which an individual may serve, some companies have included such limitations in the audit committee charter. Furthermore, the NYSE required disclosures state: “If an audit committee member simultaneously serves on the audit committee of more than three public companies, the board must determine that such simultaneous service would not impair the ability of such member to effectively serve on the listed company’s audit committee and disclose such determination either on or through the listed company’s website or in its annual proxy statement, or if the company does not file an annual proxy statement, in its annual report on Form 10-K filed with the SEC.”

2 While the existence of a continuing education program for the board and audit committee is not a requirement, the NYSE listing standards require companies to adopt and disclose guidelines for corporate governance that address their policies for directors’ continuing education.

3 A company is not required to have an audit committee financial expert, but the existence of at least one audit committee financial expert on the board is a common practice. A director who satisfies the criteria for an audit committee financial expert is presumed to satisfy the heightened financial literacy required of one member of the committee by the NYSE and NASDAQ. If the registrant provides the disclosure required by Item 407 (d)(5)(i)(A)(1) of Regulation S-K, it must disclose the name of the audit committee financial expert and whether that person is independent as independence for audit committee members is defined in the listing standards applicable to the listed company. If a company has more than one audit committee financial expert, the rules allow the company to decide whether to disclose the existence and names of other individuals who qualify. If the board determines there is no audit committee financial expert, the company must disclose this fact in its applicable SEC filing and the reason why there is none.

Committee members will be appointed by the board at the annual organizational meeting of the board to serve until their successors are elected. Unless a chairperson is elected by the full board, the members of the committee may designate a chairperson by majority vote.

The committee will meet at least quarterly, or more frequently as circumstances dictate. The committee chairperson will approve the agenda for the committee's meetings and any member may suggest items for consideration. Briefing materials will be provided to the committee as far in advance of meetings as practicable. Each regularly scheduled meeting will conclude with an executive session of the committee absent members of management. As part of its responsibility to foster open communication, the committee will meet periodically with management, the director of the internal audit function, and the independent auditor in separate executive sessions [NYSE Corporate Governance Rule 303A.7(c)(iii)(E)]. In addition, the committee will meet with the independent auditor and management to discuss the annual audited financial statements and quarterly financial statements, including the company's disclosures under "Management's Discussion and Analysis of Financial Condition and Results of Operations" [Item 303 of Regulation S-K and NYSE Corporate Governance Rule 303A.7(c)(iii)(B)].

### III. Responsibilities and duties

To fulfill its responsibilities and duties, the audit committee will:

#### Documents/reports/accounting information review

1. Review this charter at least annually and recommend to the board of directors any necessary amendments [NASDAQ Corporate Governance Rule 5605(c)(1)].
2. Meet with management and the independent auditor to review and discuss the company's annual financial statements [NYSE Corporate Governance Rule 303A.7(c)(iii)(B)] and quarterly financial statements (prior to the company's Form 10-Q filings or release of earnings), as well as all internal control reports (or summaries thereof). Review other relevant reports or financial information submitted by the company to any governmental body or the public, including management certifications as required in Item 601(b)(31) of Regulation S-K and relevant reports rendered by the independent auditor (or summaries thereof).
3. Recommend to the board whether the financial statements should be included in the annual report on Form 10-K [Item 407(d) of Regulation S-K].
4. Discuss earnings press releases, including the type and presentation of information, paying particular attention to any pro forma or adjusted non-GAAP information. Such discussions may be in general terms (i.e., discussion of the types of information to be disclosed and the type of presentations to be made) [NYSE Corporate Governance Rule 303A.7(c)(iii)(C) and general commentary to Rule 303A.7(c)].

5. Discuss financial information and earnings guidance provided to analysts and ratings agencies. Such discussions may be in general terms (i.e., discussion of the types of information to be disclosed and the type of presentations to be made) [NYSE Corporate Governance Rule 303A.7(c)(iii)(C) and general commentary to Rule 303A.7(c)].
6. Review the regular internal reports to management (or summaries thereof) prepared by the internal audit function, as well as management's response.

#### Independent auditor

7. Appoint (and recommend that the board submit for shareholder ratification, if applicable), compensate, retain, and oversee the work performed by the independent auditor retained for the purpose of preparing or issuing an audit report or related work. Review the performance and independence of the independent auditor and remove the independent auditor if circumstances warrant. The independent auditor will report directly to the audit committee and the audit committee will oversee the resolution of disagreements between management and the independent auditor if they arise [Rule 10A-3(b)(2) of the Exchange Act, NYSE Corporate Governance Rule 303A.6, and NASDAQ Corporate Governance Rule 5605(c)(3)].
8. Actively engage in dialogue with the independent auditor with respect to any disclosed relationships or services that may affect the independence and objectivity of the auditor and take appropriate actions to oversee the independence of the independent auditor [NASDAQ Corporate Governance Rule 5605(c)(1)(b)].
9. Review and preapprove (which may be pursuant to preapproval policies and procedures<sup>4</sup>) both audit and nonaudit services to be provided by the independent auditor. The authority to grant preapprovals may be delegated to one or more designated members of the audit committee, whose decisions will be presented to the full audit committee at its next regularly scheduled meeting [Rule 2-01(3)(c)(7) of Regulation S-X].
10. Consider whether the auditor's provision of permissible nonaudit services is compatible with the auditor's independence [Rule 10A-3(b)(2) of the Exchange Act, NYSE Corporate Governance Rule 303A.7(c)(i)(A)(2), and NASDAQ Corporate Governance Rule 5605(c)(1)(B)].
11. Discuss with the independent auditor the matters required to be discussed under the standards of the PCAOB [Item 407(d)(3)(i)(B) of Regulation S-K].
12. Review with the independent auditor any problems or difficulties and management's response [NYSE Corporate Governance Rule 303A.7(c)(iii)(F)].

<sup>4</sup> Any policy under which audit or nonaudit services are preapproved needs to be detailed as to the particular services and the audit committee needs to be informed of each service [Rule 2-01(3)(c)(7) of Regulation S-X].

13. Hold timely discussions with the independent auditor regarding the following:
  - All critical accounting policies and practices
  - All alternative treatments of financial information within generally accepted accounting principles related to material items that have been discussed with management, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the independent auditor
  - Other material written communications between the independent auditor and management, including, but not limited to, the management letter and schedule of unadjusted differences [Rule 2-07 of Regulation S-X].
14. At least annually, obtain and review a report by the independent auditor describing:
  - The independent auditor’s internal quality-control procedures [NYSE Corporate Governance Rule 303A.7(c)(iii)(A)]
  - Any material issues raised by the most recent internal quality-control review or peer review, or by any inquiry or investigation by governmental or professional authorities within the preceding five years with respect to independent audits carried out by the independent auditor, and any steps taken to deal with such issues [NYSE Corporate Governance Rule 303A.7(c)(iii)(A)]
  - All relationships between the independent auditor and the company [Item 407(d)(3)(i)(C) of Regulation S-K and NYSE Corporate Governance Rule 303A.7(c)(iii)(A)], addressing the matters set forth in PCAOB Rule 3526.

This report should be used to evaluate the independent auditor’s qualifications, performance, and independence. Further, the committee will review the experience and qualifications of the lead partner each year and determine that all partner rotation requirements, as promulgated by applicable rules and regulations, are executed. The committee will also consider whether there should be rotation of the independent auditor itself. The audit committee should present its conclusions to the full board [Commentary to NYSE Corporate Governance Rule 303A.7(c)(iii)(A)].

15. Set policies, consistent with governing laws and regulations, for hiring personnel of the independent auditor [NYSE Corporate Governance Rule 303A.7(c)(iii)(G)].<sup>5</sup>

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<sup>5</sup> Such policy should take into consideration the one-year “cooling-off period” for individuals in a financial reporting oversight role, such as the CEO, CFO, controller, CAO, or the equivalent, as well as other prohibited relationships under the related rules of the SEC.

### Financial reporting processes, accounting policies, and internal control structure

16. In consultation with the independent auditor and the internal audit function, review the integrity of the company's financial reporting processes (both internal and external) [NYSE Corporate Governance Rule 303A.7(c)(i)(A)].
17. Periodically review the adequacy and effectiveness of the company's disclosure controls and procedures and the company's internal control over financial reporting, including any significant deficiencies and significant changes in internal controls.
18. Understand the scope of the internal and independent auditors' review of internal control over financial reporting and obtain reports on significant findings and recommendations, together with management responses [NYSE Corporate Governance Rule 303A.7(c)(i)(A)].
19. Receive and review any disclosure from the company's CEO and CFO made in connection with the certification of the company's quarterly and annual reports filed with the SEC of: a) significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the company's ability to record, process, summarize, and report financial data; and b) any fraud, whether or not material, that involves management or other employees who have a significant role in the company's internal controls.
20. Review major issues regarding accounting principles and financial statement presentations, including any significant changes in the company's selection or application of accounting principles; major issues as to the adequacy of the company's internal controls; and any special audit steps adopted in light of material control deficiencies [General commentary to NYSE Corporate Governance Rule 303A.7(c)].
21. Review analyses prepared by management and the independent auditor setting forth significant financial reporting issues and judgments made in connection with the preparation of the financial statements, including analyses of the effects of alternative GAAP methods on the financial statements [General commentary to NYSE Corporate Governance Rule 303A.7(c)].
22. Review the effect of regulatory and accounting initiatives, as well as off-balance-sheet structures, on the financial statements of the company [General commentary to NYSE Corporate Governance Rule 303A.7(c)].
23. Review and approve all related-party transactions, defined as those transactions required to be disclosed under Items 404(a) and 404(b) of Regulation S-K; NYSE Rule 314.00; and NASDAQ Corporate Governance Rule 5630(a-b).
24. Establish and oversee procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting controls, or auditing matters, including procedures for confidential, anonymous submissions by company employees regarding questionable accounting or auditing matters [Rule 10A-3(b)(3) of the Exchange Act, NYSE Corporate Governance Rule 303A.6, and NASDAQ Corporate Governance Rule 5605(c)(3)].

### Internal audit<sup>6,7</sup>

25. Review and advise on the selection and removal of the internal audit director.
26. Review the activities and organizational structure of the internal audit function, as well as the qualifications of its personnel.
27. Annually, review and recommend changes (if any) to the internal audit charter.
28. Periodically review, with the internal audit director, any significant difficulties, disagreements with management, or scope restrictions encountered in the course of the function's work.
29. Periodically review, with the independent auditor, the internal audit function's responsibility, budget, and staffing [Commentary to NYSE Corporate Governance Rule 303A.7(c)(iii)(F)].

### Ethical compliance, legal compliance, and risk management<sup>8</sup>

30. Oversee, review, and periodically update the company's code of business conduct and ethics<sup>9</sup> and the company's system to monitor compliance with and enforce this code.
31. Review, with the company's counsel, legal compliance and legal matters that could have a significant impact on the company's financial statements.
32. Discuss policies with respect to risk assessment and risk management, including appropriate guidelines and policies to govern the process, as well as the company's major financial risk exposures and the steps management has undertaken to control them [NYSE Corporate Governance Rule 303A.7(c)(iii)(D)].
33. Consider the risk of management's ability to override the company's internal controls.

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6 Though not required, many companies have a process in place by which the internal and independent auditors evaluate each other on an annual basis. Should the audit committee choose to include the responsibility to review any such evaluations, the following language may be used: "Review the results of the annual evaluation of the internal audit function by the independent auditor and the review of the independent auditor by the internal audit function. Recommend improvements as necessary."

7 NYSE Corporate Governance Rule 303A.7(d) requires each listed company to have an internal audit function. The NYSE commentary indicates that this function does not have to be a separate department and may be outsourced if the company chooses. Language regarding the internal audit function should be reviewed and modified, if necessary, to reflect the nature and composition of such function at a given company.

8 The audit committee charter should include the items 30 through 33 if the audit committee, rather than another committee, assumes responsibilities with respect to ethical compliance.

9 NYSE Corporate Governance Rule 303A.10 and NASDAQ Corporate Governance Rule 5610 require listed companies to maintain a code of business conduct and ethics. Although the rules do not require the audit committee to be responsible for establishing, maintaining, and overseeing enforcement of this code, the rules do require the audit committee to oversee legal compliance, which, in many cases, includes the code of conduct.

### Reporting

34. Report regularly to the board regarding the execution of the audit committee's duties and responsibilities, activities, any issues encountered, and related recommendations [NYSE Corporate Governance Rule 303A.7(c)(iii)(H)].
35. Recommend to the board of directors that the audited financial statements be included in the company's annual report on Form 10-K [Item 407(d)(3)(i)(d) of Regulation S-K].
36. Review and approve the report that the SEC requires be included in the company's annual proxy statement [NYSE Corporate Governance Rule 303A.7(c)(i)(B)].

### Other responsibilities

37. Discuss, with the independent auditor, the internal audit function, and management, the extent to which changes or improvements in financial or accounting practices have been implemented.
38. Review, with management, the company's finance function, including its budget, organization, and quality of personnel.
39. Conduct an annual performance assessment relative to the audit committee's purpose, duties, and responsibilities outlined herein [NYSE Corporate Governance Rule 303A.7(c)(ii)].
40. Perform any other activities consistent with this charter, the company's bylaws, and governing laws that the board or audit committee determines are necessary or appropriate.

## Planning tool: Audit committee calendar of activities

Audit committees can use this tool to help plan their annual activities and meeting agendas. It considers the requirements for the audit committees of U.S. public companies, including NYSE- and NASDAQ-listed companies, as well as common practices in the marketplace, and it is subject to change if additional guidance is issued. The “Results From:” section indicates if the action or responsibility results from a requirement of SEC rule-making, the NYSE, the NASDAQ, or a common or emerging practice. The action or responsibility, as described, may not be an explicit legislative or regulatory requirement or proposal, but may be an action that logically results from other legislative or regulatory requirements or proposals. The “Suggested Frequency” section offers a benchmark for how often the activity could be performed, while the “Meeting Month” section provides an area where the audit committee can mark the months in which an activity should be performed. The audit committee can use this tool in conjunction with the “Sample Audit Committee Charter” and tailor it to reflect the responsibilities in the company’s audit committee charter.

This document is not an all-inclusive list of activities that an audit committee should or must execute. The planning tool contains general information only and does not constitute, and should not be regarded as, legal or similar professional advice or service. Deloitte & Touche LLP does not accept any responsibility for any errors this publication may contain, whether caused by negligence or otherwise, or for any losses, however caused, sustained by any person that relies on it. The information presented can and will change; we are under no obligation to update such information. Deloitte & Touche LLP makes no representations as to the sufficiency of these

tools for your purposes, and, by providing them, we are not rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. These tools should not be viewed as a substitute for such professional advice or services, nor should they be used as a basis for any decision that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional adviser. Deloitte & Touche LLP does not assume any obligations as a result of your access to or use of these tools.

This planning tool is designed for U.S. public companies; exceptions to the requirements noted below may apply for certain issuers, including investment companies, small-business issuers, and foreign private issuers. Many of the items presented here are not applicable to voluntary filers. All companies should consult with legal counsel regarding the applicability and implementation of the various activities identified.

Action/responsibility	Results from:				Suggested frequency	Meeting month											
	SEC requirement	NYSE listing standards	NASDAQ listing standards	Common practice		January	February	March	April	May	June	July	August	September	October	November	December
<b>General responsibilities</b>																	
Monitor audit committee members' compliance with applicable independence rules and regulations.	■	■	■		Ongoing												
As necessary, engage outside legal, accounting, or other advisers and provide funding to compensate those advisers.	■	■	■		As needed												
Report regularly to the board of directors regarding the execution of duties and responsibilities.		■		■	Each board meeting												
Review the financial literacy and expertise of all audit committee members. Determine audit committee financial expert status and determine that members are in compliance with applicable rules and regulations.	■	■	■		Annually												
Disclose in the Form 10-K (or equivalent annual filing) whether at least one member of the audit committee has been determined to be an "audit committee financial expert," as defined by the SEC. If the board determines that someone on the audit committee meets the definition, disclose his/her name and whether he/she is independent. If more than one audit committee member is determined to fulfill the definition, determine if the names and independence of those individuals will be disclosed. If there is not an audit committee financial expert, disclose why not.	■				Annually												
Conclude each regular audit committee meeting with an executive session of the committee, without members of management.				■	Each audit committee meeting												
Periodically, meet with management privately to discuss any necessary matters.		■		■	Quarterly												
Consider and plan for succession of audit committee members.				■	Annually												
Review, with management, the company's finance function, including its budget, organization and quality of personnel.				■	Annually												

Action/responsibility	Results from:				Suggested frequency	Meeting month											
	SEC requirement	NYSE listing standards	NASDAQ listing standards	Common practice		January	February	March	April	May	June	July	August	September	October	November	December
<b>Review of financial/controls information</b>																	
Review and discuss with management and the independent auditor the company's annual financial statements prior to filing, including the company's disclosure under "Management's Discussion and Analysis of Financial Condition and Results of Operations."	■	■			Annually												
Recommend to the board of directors whether the financial statements should be included in the annual report on Form 10-K.	■				Annually												
Review and discuss with management and the independent auditor the company's quarterly financial statements prior to their filing, including the company's disclosure under "Management's Discussion and Analysis of Financial Condition and Results of Operations."		■		■	Quarterly												
Review the internal controls report.	■				Annually												
Review management certifications required by the SEC.	■				Quarterly												
Review other reports rendered by the independent auditor and submitted by the company to any governmental body or the public.				■	As needed												
Discuss earnings press releases, including the type and presentation of information, paying particular attention to any pro forma or adjusted non-GAAP information. This discussion may be in general terms.		■		■	Quarterly												
Discuss the financial information and earnings guidance provided to analysts and ratings agencies. This discussion may be in general terms.		■		■	Annually												
Review the regular internal reports to management prepared by the internal audit function and management's response.				■	Semiannually												

Action/responsibility	Results from:				Suggested frequency	Meeting month											
	SEC requirement	NYSE listing standards	NASDAQ listing standards	Common practice		January	February	March	April	May	June	July	August	September	October	November	December
<b>Independent auditor relationship</b>																	
Appoint the independent auditor.	■	■			Annually												
Compensate, retain, and oversee the work of the independent auditor for the purpose of preparing or issuing an audit report or related work.	■	■			Ongoing												
Review the performance of the independent auditor, including the lead audit partner. Ensure that partners are rotated in accordance with applicable requirements.		■		■	Annually												
Preapprove audit and nonaudit services provided by the independent auditor.	■				In accordance with policy (as necessary)												
Consider the independence of the auditor, including engaging in dialogue with the independent auditor with respect to any disclosed relationships or services that may affect the independence, objectivity, and professional skepticism of the auditor, and take appropriate actions to oversee independence.		■		■	Annually and as needed												
Oversee the resolution of disagreements between management and the independent auditor if they arise.	■				As needed												
Review with the independent auditor any problems or difficulties encountered in the course of the audit and management's response.		■			Annually												
Review the audit plan and scope with the independent auditor.				■	Annually												

Action/responsibility	Results from:				Suggested frequency	Meeting month												
	SEC requirement	NYSE listing standards	NASDAQ listing standards	Common practice		January	February	March	April	May	June	July	August	September	October	November	December	
<p>Prior to filing periodic financial statements, receive the report from the independent auditor required by Rule 2-07 of Regulation S-X. This report includes:</p> <ul style="list-style-type: none"> <li>- Critical accounting policies</li> <li>- Alternative treatments of financial information within GAAP related to material items that have been discussed with management, the ramifications of using these alternative disclosures and treatments, and the treatment preferred by the independent auditor</li> <li>- Other material written communications between the independent auditor and management, including (but not limited to) the management letter and schedule of unadjusted differences.</li> </ul>	■				As reported by the independent auditor													
Receive from the independent auditor the communications required by the standards of the PCAOB.				■	As reported by the independent auditor													
Periodically, meet with the independent auditor privately to discuss any matters necessary.		■		■	Quarterly													
Review hiring policies for personnel of the independent auditor.		■		■	As needed													
<p>Obtain and review a report by the independent auditor describing:</p> <ul style="list-style-type: none"> <li>- The independent auditor's internal quality-control procedures</li> <li>- Any material issues raised by the most recent internal quality-control review, peer review, or any inquiry or investigation by governmental or professional authorities, within the preceding five years, with respect to independent audits carried out by the independent auditor, and any steps taken to deal with such issues</li> <li>- All relationships between the independent auditor and the company.</li> </ul>		■			Annually													

Action/responsibility	Results from:				Suggested frequency	Meeting month											
	SEC requirement	NYSE listing standards	NASDAQ listing standards	Common practice		January	February	March	April	May	June	July	August	September	October	November	December
<b>Financial reporting processes, accounting policies, and internal control</b>																	
In consultation with the independent auditor and the internal audit function, review the integrity of the company's financial reporting processes (both internal and external) and the internal control structure (including disclosure controls and procedures and internal control over financial reporting).				■	Quarterly												
Meet with representatives of the disclosure committee to discuss any anomalies encountered in the management certification process.				■	Quarterly												
Review with management major issues regarding accounting principles and presentation of the financial statements, including any significant changes in the company's selection or application of accounting principles, major issues as to the adequacy of the company's internal controls, and any special audit steps adopted in response to material control deficiencies.		■		■	Quarterly												
Review management's analyses of financial reporting issues and judgments made in connection with the preparation of the financial statements, including analyses of the effects of alternative GAAP methods on the financial statements.		■		■	Quarterly												
Review with management the effect of regulatory and accounting initiatives, as well as off-balance-sheet structures, on the financial statements of the company.		■		■	As needed												
Review and approve all related-party transactions.		■		■	Quarterly												
Review the adequacy of procedures for the receipt, retention, and treatment of complaints regarding accounting, internal control, or auditing matters, including procedures for confidential, anonymous submissions by company employees.	■	■			Annually												
Receive and review reports or complaints of questionable accounting, auditing, or internal control matters.	■	■			Semiannually or quarterly												

Action/responsibility	Results from:				Suggested frequency	Meeting month											
	SEC requirement	NYSE listing standards	NASDAQ listing standards	Common practice		January	February	March	April	May	June	July	August	September	October	November	December
<b>Internal audit activities</b>																	
Review and advise on the selection or removal of the internal audit director.				■	As needed												
Meet with the director of the internal audit function privately to discuss any necessary matters.		■		■	Quarterly												
Review with the internal audit director any significant difficulties, disagreements with management, or scope restrictions encountered in the course of the function's work.				■	Annually												
Review the activities and organizational structure of the internal audit function, as well as the qualifications of its personnel.				■	Annually												
Review the internal audit charter and recommend any necessary changes.				■	Annually												
Discuss, with the independent auditor, the internal audit function's responsibilities, budget, and staffing.		■		■	Annually												
<b>Ethical compliance, legal compliance, and risk management</b>																	
Review the company's code of ethical conduct and the company's systems to monitor compliance with and enforce this code. Determine whether the code is in compliance with applicable rules and regulations.				■	Annually												
Receive and review reports of code violations and how they were identified and treated.				■	Quarterly												
In consultation with the company's legal counsel, review legal compliance and legal and regulatory matters that could have a significant impact on the organization's financial statements.		■		■	Semiannually or more often as needed												
Discuss with management significant risk exposures, including major financial and accounting risk exposures, and the steps taken by management to control them.		■		■	Annually												

Action/responsibility	Results from:				Suggested frequency	Meeting month											
	SEC requirement	NYSE listing standards	NASDAQ listing standards	Common practice		January	February	March	April	May	June	July	August	September	October	November	December
<b>Other responsibilities</b>			■	■	Annually												
Review the audit committee charter; recommend to the board of directors any necessary amendments, as conditions dictate.			■	■	Annually												
Review, with the independent auditor, the internal audit function, and management, the extent to which changes or improvements in financial or accounting practices have been implemented.				■	Annually												
Receive and approve the report that the SEC requires to be included in the company's annual proxy statement.	■	■			Annually												
Participate in appropriate continuing education.				■	As needed												
Assess performance relative to the audit committee's purpose, duties, and responsibilities.		■		■	Annually												

## Financial literacy self-assessment tool

Deloitte's financial literacy self-assessment tool includes questions on financial accounting and reporting issues. Please note that some of the questions relate to issues faced only by SEC registrants. These multiple-choice questions are not intended to cover all topics that an audit committee member may need to understand to be considered financially literate for the company he or she serves. This tool was designed as a self-assessment for members who want to evaluate their financial literacy.

In addition to the concepts presented in the tool, audit committee members should consider whether they can answer questions on key accounting and reporting issues such as:

### Do I understand the revenue recognition policy of the company?

#### **Considerations:**

- How is cash generated by the sales of the company's products and services?
- Are there significant sales to related parties? If so, are the disclosures adequate?
- Is a large portion of the company's revenue recorded at the end of a fiscal period? If so, are the cut-off procedures adequate?
- How do the company's revenue recognition policies differ from those of others in the industry?

### Which amounts and balances in the financial statements are subject to the highest level of management judgment?

#### **Considerations:**

- Does the company have significant employee benefit obligations? If so, what key assumptions have been used to calculate the related liability?
- Is the company self-insured for general liability, workers' compensation, or other risks typically covered by insurance? If so, how are the reserve requirements estimated and what were the key assumptions used in the estimates?
- How does the company calculate significant reserves, such as warranty, bad debt, and inventory reserves?
- If fair value is the appropriate measure for an asset or liability, what is the process for determining fair value and how has management established the underlying assumptions?
- What criteria has management used to determine if an asset is impaired?

### Are the company's disclosures adequate?

#### **Considerations:**

- What are the company's most significant accounting policies?
- Who are the company's significant related parties?
- Does the company have unique financing arrangements?
- Is the company's capital structure complex?

Deloitte has also created a self-assessment tool. Audit committees are encouraged to consider and tailor this tool as part of a broad assessment of financial literacy.

#### **I. Financial statements and accounting literature**

1. The balance sheet:
  - a. Is a financial snapshot, taken at a point in time, of the assets the company owns and the claims against those assets.
  - b. Records the flow of financial resources over time.
  - c. Reports the operating results of a company for a period of time.
  - d. Is prepared by the auditors.
  - e. Both a and d are correct.
2. Shareholders' equity (owners' equity, stockholders' equity, net worth, or equity):
  - a. Is a source of reserve assets consisting of undistributed income.
  - b. Is the amount of cash contributed by the shareholders.
  - c. Includes shareholder contributions and undistributed income.

- d. Is dependent on the company's stock price fluctuations.
  - e. Both c and d are correct.
3. Basic earnings per share (EPS) is calculated by:
    - a. Dividing net income by the number of common shares outstanding at the end of the reporting period.
    - b. Dividing net income by the weighted average number of preferred and common stock outstanding during the reporting period.
    - c. Dividing income before taxes by the number of common shares outstanding at the end of the reporting period.
    - d. Dividing net income attributable to common shareholders by the weighted average number of common shares outstanding during the reporting period.
    - e. Varies from company to company.
  4. Financial statements to be filed with the SEC should be prepared:
    - a. Following the IRS code.
    - b. As the company's financing agreements dictate or prescribe.
    - c. Following generally accepted accounting principles (GAAP).
    - d. Using the practices followed by others in the same industry.
    - e. All of the above.

5. The term "cookie jar reserve" has been used to refer to:
  - a. A vehicle that allows management to smooth earnings by reducing income in good years and increasing income in bad years.
  - b. Any liability or contra-asset that is larger than what management can justify.
  - c. A reserve that is created using overly conservative estimates.
  - d. All of the above.
6. Which of the following balance sheet items generally do NOT require management to make significant judgments and/or estimates?
  - a. Inventory at lower of cost or market.
  - b. Net receivables.
  - c. Cash.
  - d. Accrued liabilities.
  - e. Both a and c are correct.
7. A company should only consolidate its financial statements with a company in which it owns 50 percent or more equity shares.
  - a. True.
  - b. False.
8. Which of the following is NOT true of related-party transactions?
  - a. Only transactions requiring material cash payments between related parties need to be disclosed.
  - b. A company cannot indicate in its financial statements that related-party transactions were consummated under terms that were similar to those that could have been achieved in an arms-length transaction unless this representation can be substantiated.
  - c. The substance of related-party transactions is more important than their form.
  - d. All of the above are true of related-party transactions.
9. A sale can be recorded when delivery has NOT occurred if several criteria are met, including:
  - a. Risk of ownership has passed to the buyer.
  - b. There is a sales commitment.
  - c. There is a fixed delivery date.
  - d. All of the above are required.
  - e. Both a and c are required.
10. Management is required to record any adjustments that the auditors propose.
  - a. True.
  - b. False.
11. An amount is always immaterial to the financial statements if it is less than:
  - a. 10 percent of income before taxes.
  - b. 10 percent of shareholders equity.
  - c. 2 percent of net assets.
  - d. None of the above.

12. Financial ratios are tools that allow you to understand the complete economic picture of a company without having to understand any of its accounting policies.
  - a. True.
  - b. False.
13. The quick (acid-test) ratio, a tool used to assess a company's liquidity and ability to meet its obligations, is defined as:

$\text{Current assets} - \text{Inventory} \div \text{Current liabilities}$

- a. True.
- b. False.

## II. Disclosure rules

1. Which of the following does not contain financial disclosures that are subject to SEC regulations?
  - a. Management discussion and analysis (MD&A).
  - b. Earnings announcements.
  - c. The company's financial statements.
  - d. All of the above may contain financial disclosures that are subject to SEC regulations.
  - e. Both a and c contain financial disclosures.
2. Which of the following financial information is covered by the independent auditors' report?
  - a. Earnings announcements.
  - b. Pro forma earnings releases.
  - c. The footnotes to the financial statements.
  - d. MD&A.
  - e. All of the above.

3. Which of the following items is NOT expected to be addressed in MD&A?
  - a. The most critical accounting policies used to prepare the financial statements.
  - b. Liquidity and capital resources.
  - c. Information that helps investors assess how current trends and uncertainties may affect the company.
  - d. All of the above are expected to be addressed in MD&A.
4. Which of the following is NOT a required disclosure for a significant loan agreement under FASB codification topic 470 (formerly SFAS 47 or 129)?
  - a. Interest rate.
  - b. Default or breach of covenants.
  - c. Name of the lender.
  - d. Schedule of maturity.
  - e. All of the above are required to be disclosed.
5. If a company presents permitted non-GAAP measures, such amounts:
  - a. Should be disclosed along with a detailed reconciliation to, or from, GAAP amounts, and the amount of each item should be disclosed.
  - b. Must have a footnote that explains in general terms how the amount was calculated—typically a formula is sufficient.
  - c. Have been banned by the SEC under the antifraud provisions of the federal securities laws.
  - d. Both a and c are correct.

6. Non-cash charges, such as for asset impairments:
  - a. Should be ignored during most analyses, as they do not have an impact on the cash flows of the company.
  - b. Should be ignored during most analyses only if they are nonrecurring charges and are not indicative of the ongoing operations of the company.
  - c. Can be put “below the line” on the income statement to signal to investors that the item should be removed before analysis.
  - d. Are the results of situations that may have diminished the economic value of the company.
  - e. None of the above.

### III. Form and content of SEC filings

1. The primary objective of the SEC is to prevent the sale of risky or speculative securities.
  - a. True.
  - b. False.
2. Which of the following is NOT a required SEC filing?
  - a. Private equity offering.
  - b. Annual and quarterly reports.
  - c. Annual proxy statement.
  - d. Registration statements.
  - e. Both b and d.

3. Which of the following is true about the Form 10-K?
  - a. Contains the annual financial statements of the company.
  - b. Contains an audit report on the annual financial statements of the company.
  - c. Is subject to SEC review.
  - d. All of the above are true.
4. Which of the following is NOT true about the Form 10-Q?
  - a. Contains the quarterly financial statements of the company.
  - b. Contains an audit report on the quarterly financial statements of the company.
  - c. Is subject to SEC review.
  - d. Contains footnotes to the financial statements.
5. A Form 8-K is required to be filed:
  - a. After a significant acquisition.
  - b. After a change in auditors.
  - c. A company is never required to file a Form 8-K, but companies often do so at their own discretion to notify investors of significant events.
  - d. Both a and b.
6. Which of the following is required XBRL-tagged information?
  - a. Financial statements.
  - b. Notes to the financial statements.
  - c. Financial statement schedules.
  - d. All of the above.

#### IV. Internal control

1. Internal control is designed to provide reasonable assurance over the:
  - a. Effectiveness and efficiency of operations.
  - b. Reliability of financial reporting.
  - c. Compliance with applicable laws and regulations.
  - d. All of the above.
  - e. Both b and c.
2. An effective system of internal control over financial reporting will always prevent and detect fraud.
  - a. True.
  - b. False.
3. Who is responsible for the design and operating effectiveness of the company's internal control over financial reporting?
  - a. Management.
  - b. Internal auditor.
  - c. Independent auditor.
  - d. The audit committee.
  - e. All of the above.
4. Under the SEC's management certification requirements in Item 307 of Regulation S-K, management is required to certify that it has disclosed which of the following to its auditor and audit committee?
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize, and report financial information.
  - b. The method used in designing the company's internal control framework.
  - c. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.
  - d. Both a and c are correct.
5. Which of the following organizations developed the internal control framework generally used by public companies in the United States?
  - a. The Accounting and Internal Controls Program Administration.
  - b. The Committee of Sponsoring Organizations of the Treadway Commission.
  - c. The Public Company Accounting Oversight Board.
  - d. The Securities and Exchange Commission.

## V. Answer key

### I. Financial statements and accounting literature

1. **A is correct.** The objective of the balance sheet is to present the financial condition of a company at a particular point in time.
2. **C is correct.** Shareholders' equity may include a number of other items as well, such as treasury stock and certain unrealized gains and losses.
3. **D is correct.** The calculation of basic EPS includes net income attributable to common shareholders as its numerator, not income before taxes. This calculation uses the weighted average number of shares outstanding during the reporting period as its denominator. It does not include preferred stock. Detailed guidance on earnings per share can be found in FASB codification topic 260 (formerly SFAS 128, *Earnings per Share*).
4. **C is correct.** Financial statements filed with the SEC are required to be in accordance with GAAP.
5. **D is correct.** "Cookie jar reserve" is a term that was used by former SEC Chairman Arthur Levitt to refer to accruals and other estimates used by management at some companies to manage earnings. Management should evaluate most contingent liabilities using the guidance of FASB codification topic 450 (formerly SFAS 5, *Accounting for Contingencies*).
6. **C is correct.** Many balance sheet items require significant estimates or judgments, including inventory (e.g., obsolescence reserves), accounts receivable (e.g., allowance for doubtful accounts), and accrued liabilities (e.g., warranty reserves).
7. **B is correct.** The consolidation model, as amended by SFAS 167, *Amendments to FASB Interpretation No. 46(R)*, is based on power and economics. When a company has (1) the power to direct the activities of a variable-interest entity that most significantly affect its economic performance, and (2) the obligation to absorb losses or the right to receive benefits that could potentially be significant to the variable-interest entity, it is the primary beneficiary.
8. **A is correct.** The materiality of the cash payments between related parties is not relevant to determine if a transaction needs to be disclosed. A noncash transaction between related parties also must be disclosed.
9. **D is correct.** Refer to the SEC's Staff Accounting Bulletin No. 101 and 104, *Revenue Recognition in Financial Statements*, for further guidance.
10. **B is correct.** Management is not required to record proposed audit adjustments; however, if the auditors determine that the financial statements are materially misstated, they will qualify their opinion accordingly.

11. **D is correct.** The calculation of materiality is a matter of professional judgment, considering qualitative and quantitative factors, and there is no single threshold that is applied to all companies.
12. **B is correct.** Financial ratios have less value without an understanding of the accounting policies used by a company to prepare the financial statements.
13. **A is correct.** The quick ratio is an indicator of a company's short-term liquidity.

## II. Disclosure rules

1. **D is correct.** All of the items contain financial disclosures. MD&A and financial statements will contain financial disclosures and are typically presented in a Form 10-K for domestic registrants. Earnings announcements for public companies also contain financial disclosures that are subject to SEC rules and regulations, including Regulation G, *Disclosure of Non-GAAP Financial Measures*.
2. **C is correct.** Although all of these items include accounting information, a, b, and d are not covered by the independent auditors' report.

3. **D is correct.** All of these items are expected to be discussed in MD&A. Critical accounting estimates are required by Financial Reporting Release No. 72, *Commission Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*. Liquidity and capital resources and material trends and uncertainties disclosures are required by Item 303 of Regulation S-K, *Management's Discussion and Analysis of Financial Condition and Results of Operations*.
4. **C is correct.** There is no GAAP requirement to disclose the name of the lender; however, all of the remaining items must be disclosed for each material loan agreement.
5. **A is correct.** In conjunction with the Sarbanes-Oxley Act, the SEC adopted rules governing the use of non-GAAP financial measures. Issuers using non-GAAP financial measures are required to provide, (i) directly comparable GAAP financial measures presented with equal or greater prominence, (ii) a reconciliation between GAAP and non-GAAP financial measures, (iii) a statement disclosing the reasons management believes the non-GAAP financial measures are useful, and (iv) if material, additional purposes for which management uses the financial measure. See Regulation G and Item 10(e) of Regulation S-K, Item 10, for authoritative guidance. For additional staff interpretative information on non-GAAP financial measures, refer to Topic 8 of the Division of Corporation Finance's *Financial Reporting Manual*.

6. **D is correct.** Noncash transactions are often disregarded as “paper losses,” as they do not result from cash outflows; however, these transactions—for example, the write-down of a significant investment—clearly have negative economic implications to the company and in many instances require appropriate disclosure.

### *III. Form and content of SEC filings*

1. **B is correct.** The SEC’s primary mission is to protect investors and maintain the integrity of the securities markets. Its focus is to provide timely and accurate information for investors to make informed investment choices, not to restrict risky or speculative issuances.
2. **A is correct.** All of the remaining items are required SEC filings.
3. **D is correct.** A Form 10-K is an annual report that contains the financial statements of a public company and the financial statements included in the filing are required to be audited by an independent registered public accounting firm. The SEC is required to review each registrant at least once every three years, but the SEC staff is not required to issue a comment letter for all reviews. Therefore, Form 10-Ks are subject to SEC review.

4. **B is correct.** A Form 10-Q is a quarterly report that contains the financial statement of a public company. Although the financial statements included in the Form 10-Q must be reviewed by an independent registered public accounting firm, the firm is not required to audit the interim period. Further, the firm is not required to issue a review report, and even if a review report is issued, it is not required to be included in the Form 10-Q. The SEC is required to review each registrant at least once every three years, but the SEC staff is not required to issue a comment letter for all reviews. Therefore, Form 10-Qs are subject to SEC review.
5. **D is correct.** The instructions to Form 8-K require public companies to file Form 8-Ks when certain events occur. Those include significant acquisitions and changes in auditors.
6. **D is correct.** Financial statements, notes to the financial statements, and financial statement schedules are all required to be XBRL-tagged information for certain SEC registrants. The SEC’s final rule on XBRL permits, but does not require, registrants to tag each qualitative (narrative) disclosure. It also states that tagging of MD&A disclosures is “neither required nor permitted” and that the SEC will “continue to consider, however, the advisability of permissible optional or required interactive data for disclosures made outside a set of financial statements prepared in accordance with U.S. GAAP.” The requirement is being phased in.

#### IV. Internal controls

1. **D is correct.** Internal control is broadly defined as a process, affected by an entity's board of directors, management, and other personnel, that is designed to provide reasonable assurance regarding achievement of objectives. From the perspective of preparing financial statements, answer b is applicable. The SEC states that "internal control over financial reporting is a process designed by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP and includes those policies and procedures that—
  - a. Pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company;
  - b. Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and
  - c. Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements."
2. **B is correct.** An effective system of ICFR should provide reasonable assurance that material misstatement of the financial statements due to fraud and error will be prevented or detected, but cannot provide absolute assurance.
3. **A is correct.** For public companies, Item 308 of Regulation S-K requires management to explicitly state responsibility for ICFR in a Form 10-K filing. Also, under Section 404 of the Sarbanes-Oxley Act of 2002, management is required to certify its responsibility for establishing and maintaining adequate ICFR in periodic filings.
4. **D is correct.** SEC regulations require disclosure of both a and c. Management must certify that it has communicated fraud, whether or not material, as well as significant deficiencies and material weaknesses in the company's ICFR to its auditor and the audit committee. B is a requirement under Section 404 of the Sarbanes-Oxley Act and pertains to management's annual ICFR report. It is not a requirement under Rule 302.

5. **B is correct.** The Committee of Sponsoring Organizations of the Treadway Commission (COSO) is an organization dedicated to improving the quality of financial reporting through effective business ethics, corporate governance, and internal controls. This committee has issued the *Internal Control – Integrated Framework* and other guidance, including *Guidance on Monitoring Internal Control Systems*, on implementing the framework.

#### Commitment to effective corporate governance

Deloitte has a number of programs and initiatives that demonstrate its commitment to helping boards and audit committees enhance their effectiveness and overall corporate governance.

#### Center for Corporate Governance

The Deloitte Center for Corporate Governance is a resource for executives, directors, and the governance community on the latest and most relevant corporate governance trends, regulations, and leading practices. The center generates research and roundtables on current boardroom issues and conducts periodic Dbrief webcasts on governance topics. The [Center for Corporate Governance website](http://www.corpgov.deloitte.com) at [www.corpgov.deloitte.com](http://www.corpgov.deloitte.com) offers timely, relevant, and balanced governance information for boards of directors, senior executives, investors, and others interested in governance.

#### Governance services

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## Audit committee performance evaluation

The following questionnaire is based on emerging and leading practices to assist in the self-assessment of an audit committee's performance. It is not intended to be all inclusive.

When completing the performance evaluation, consider the following process:

- Select a coordinator and establish a timeline for the process.
- In addition to audit committee members completing the form as a self-evaluation, ask individuals who interact with the audit committee members to provide feedback.
- Ask each audit committee member to complete an evaluation by selecting the rating that most closely reflects the audit committee's performance related to each practice.
- Consolidate the results into a summarized document for discussion and review by the committee.

For each of the following statements, select a number between 1 and 5, with 1 indicating that you strongly disagree and 5 indicating that you strongly agree with the statement. Select 0 if the point is not applicable or you do not have enough knowledge or information to rank the organization's audit committee on a particular statement.

<i>Circle one number for each statement</i>	Insufficient knowledge	Strongly disagree	Neither agree nor disagree	Strongly agree		
<b>Composition and Quality</b>						
1. Qualified audit committee members are identified by sources independent of management (e.g., independent board members assisted by an outside search firm).	0	1	2	3	4	5
2. Audit committee members have the appropriate qualifications to meet the objectives of the audit committee's charter, including appropriate financial literacy.	0	1	2	3	4	5
3. The audit committee demonstrates integrity, credibility, trustworthiness, active participation, an ability to handle conflict constructively, strong interpersonal skills, and the willingness to address issues proactively.	0	1	2	3	4	5
4. The audit committee demonstrates appropriate industry knowledge and includes a diversity of experiences and backgrounds.	0	1	2	3	4	5
5. Members of the audit committee meet all applicable independence requirements.	0	1	2	3	4	5
6. The audit committee participates in a continuing education program to enhance its members' understanding of relevant accounting, reporting, regulatory, auditing, and industry issues.	0	1	2	3	4	5
7. The audit committee monitors compliance with corporate governance regulations and guidelines.	0	1	2	3	4	5
8. The audit committee reviews its charter annually to determine whether its responsibilities are described adequately and recommends changes to the board for approval.	0	1	2	3	4	5
9. New audit committee members participate in an orientation program to educate them on the company, their responsibilities, and the company's financial reporting and accounting practices.	0	1	2	3	4	5
10. The audit committee chairman is an effective leader.	0	1	2	3	4	5

<i>Circle one number for each statement</i>	Insufficient knowledge	Strongly disagree	2	Neither agree nor disagree	3	4	Strongly agree
11. The audit committee, in conjunction with the nominating committee (or its equivalent), creates a succession and rotation plan for audit committee members, including the audit committee chairman.	0	1	2	3	4	5	
<b>Understanding the Business, including Risks</b>							
12. The audit committee considers or knows that the full board or other committees take into account significant risks that may directly or indirectly affect financial statement reporting. Examples include: <ul style="list-style-type: none"> <li>• Regulatory and legal requirements</li> <li>• Concentrations (e.g., suppliers and customers)</li> <li>• Market and competitive trends</li> <li>• Financing and liquidity needs</li> <li>• Financial exposures</li> <li>• Business continuity</li> <li>• Company reputation</li> <li>• Financial strategy execution</li> <li>• Financial management’s capabilities</li> <li>• Management override</li> <li>• Fraud control</li> <li>• Company pressures, including “tone at the top”</li> </ul>	0	1	2	3	4	5	
13. The audit committee considers, understands, and approves the process implemented by management to effectively identify, assess, and respond to the organization’s key risks.	0	1	2	3	4	5	
14. The audit committee understands and approves management’s fraud risk assessment and has an understanding of identified fraud risks.	0	1	2	3	4	5	
15. The audit committee considers the company’s performance versus that of its peers in a manner that enhances comprehensive risk oversight by using reports provided directly by management to the audit committee or at the full board meeting. These may include benchmarking information comparing the company’s financial performance and ratios with industry competitors and peers, industry trends, analyst estimates, and budget analysis with explanations for areas where significant differences are apparent.	0	1	2	3	4	5	

<i>Circle one number for each statement</i>	Insufficient knowledge	Strongly disagree	Neither agree nor disagree	Strongly agree		
<b>Process and Procedures</b>						
16. The audit committee reports its proceedings and recommendations to the board after each committee meeting.	0	1	2	3	4	5
17. The audit committee develops a calendar that dedicates the appropriate time and resources needed to execute its responsibilities.	0	1	2	3	4	5
18. Audit committee meetings are conducted effectively, with sufficient time spent on significant or emerging issues.	0	1	2	3	4	5
19. The level of communication between the audit committee and relevant parties is appropriate; the audit committee chairman encourages input on meeting agendas from committee and board members, management, the internal auditors, and the independent auditor.	0	1	2	3	4	5
20. The audit committee sets clear expectations and provides feedback to the full board concerning the competency of the organization's CFO and senior financial management.	0	1	2	3	4	5
21. The audit committee has input into the succession planning process for the CFO.	0	1	2	3	4	5
22. The agenda and related information (e.g., prior meeting minutes, press releases, financial statements) are circulated in advance of meetings to allow audit committee members sufficient time to study and understand the information.	0	1	2	3	4	5
23. Written materials provided to audit committee members are relevant and concise.	0	1	2	3	4	5
24. Meetings are held with enough frequency to fulfill the audit committee's duties and at least quarterly, which should include periodic visits to company locations with key members of management.	0	1	2	3	4	5
25. Regularly, audit committee meetings include separate private sessions with management and the internal and independent auditors.	0	1	2	3	4	5
26. The audit committee maintains adequate minutes of each meeting.	0	1	2	3	4	5
27. The audit committee and the compensation committee regularly review management incentive plans to consider whether the incentive process is appropriate.	0	1	2	3	4	5

<i>Circle one number for each statement</i>	Insufficient knowledge	Strongly disagree	Neither agree nor disagree	Strongly agree		
28. The audit committee meets periodically with the committee responsible for reviewing the company's disclosure procedures.	0	1	2	3	4	5
29. The audit committee respects the line between oversight and management of the financial reporting process.	0	1	2	3	4	5
30. Audit committee members come to meetings well prepared.	0	1	2	3	4	5
<b>Oversight of the Financial Reporting Process, including Internal Controls</b>						
31. The audit committee considers the quality and appropriateness of financial accounting and reporting, including the transparency of disclosures.	0	1	2	3	4	5
32. The audit committee reviews the company's significant accounting policies.	0	1	2	3	4	5
33. The audit committee understands and approves the process used by management to identify and disclose related-party transactions.	0	1	2	3	4	5
34. The audit committee has a process for reviewing quarterly and annual earnings releases, including pro forma or non-GAAP information and other significant financial information or earnings guidance, with management and the independent auditor.	0	1	2	3	4	5
35. The audit committee oversees the organization's external financial reporting and internal control over financial reporting. This oversight includes a process for reviewing Forms 10-Q and 10-K (including management's discussion and analysis), proxies, and other filings before they are issued and providing comments to management and the independent auditor when applicable.	0	1	2	3	4	5
36. The audit committee reviews the processes related to financial statement certifications made by the CEO and the CFO.	0	1	2	3	4	5
37. The audit committee receives sufficient information to assess and understand management's process for evaluating the organization's system of internal controls (e.g., financial reporting and disclosure controls, operation controls, compliance controls) and also believes that management's scope of internal control testing adequately supports its internal control assessment.	0	1	2	3	4	5

<i>Circle one number for each statement</i>	Insufficient knowledge	Strongly disagree	Neither agree nor disagree	Strongly agree		
38. The audit committee understands and gives appropriate consideration to the internal control testing conducted by management, the internal auditors, and the independent auditor to assess the process for detecting internal control issues or fraud. Any significant deficiencies or material weaknesses that are identified are addressed, reviewed, and monitored by the audit committee.	0	1	2	3	4	5
39. The audit committee makes inquiries of the independent auditor, internal auditors, and management on the depth of experience and sufficiency of the company's accounting and finance staff.	0	1	2	3	4	5
40. The audit committee reviews the management recommendation letters written by the independent and internal auditors and monitors the process to determine that all significant matters are addressed.	0	1	2	3	4	5
41. The audit committee oversees that management takes action to achieve resolution when there are repeat comments from auditors, particularly those related to internal controls.	0	1	2	3	4	5
42. Adjustments to the financial statements that resulted from the audit are reviewed by the audit committee, regardless of whether they were recorded by management.	0	1	2	3	4	5
43. The audit committee is consulted when management is seeking a second opinion on an accounting or auditing matter.	0	1	2	3	4	5
<b>Oversight of Audit Functions</b>						
44. The audit committee understands the coordination of work between the independent and internal auditors and clearly articulates its expectations of each.	0	1	2	3	4	5
45. The audit committee regularly reviews the adequacy of the internal audit function (e.g., the charter; audit plan; budget; compliance; and number, quality, and continuity of staff).	0	1	2	3	4	5
46. The audit committee oversees the role of the internal audit director from selection to termination (e.g., appointment, evaluation, compensation, and retention) and provides feedback at least annually.	0	1	2	3	4	5

<i>Circle one number for each statement</i>	Insufficient knowledge	Strongly disagree	Neither agree nor disagree	Strongly agree		
47. The internal audit reporting lines established with the audit committee promote an atmosphere where significant issues that might involve management will be brought to the attention of the audit committee.	0	1	2	3	4	5
48. The audit committee appropriately considers internal audit reports, management's responses, and steps toward improvement.	0	1	2	3	4	5
49. The audit committee oversees the role of the independent auditor from selection to termination and has an effective process to evaluate the independent auditor's qualifications and performance.	0	1	2	3	4	5
50. The audit committee considers the independent audit plan and provides recommendations.	0	1	2	3	4	5
51. The audit committee reviews the audit fees paid to the independent auditors.	0	1	2	3	4	5
52. The audit committee comprehensively reviews management's representation letters to the independent auditor, including making inquiries about any difficulties in obtaining the representations.	0	1	2	3	4	5
53. The audit committee preapproves all audit and nonaudit services provided by the independent auditor and considers the scope of the nonaudit services provided.	0	1	2	3	4	5
54. The audit committee reviews other professional services that relate to financial reporting (e.g., consulting, legal, and tax strategy services) provided by outside consultants.	0	1	2	3	4	5
55. The audit committee monitors the process to determine that the independent auditor's partners are rotated in accordance with applicable rules.	0	1	2	3	4	5
56. The audit committee has private executive sessions with management and the internal and independent auditor that result in candid discussion of pertinent issues.	0	1	2	3	4	5

<i>Circle one number for each statement</i>	Insufficient knowledge	Strongly disagree	Neither agree nor disagree	Strongly agree		
<b>Ethics and Compliance</b>						
57. Audit committee members oversee the process and are notified of communications received from governmental or regulatory agencies related to alleged violations or areas of noncompliance.	0	1	2	3	4	5
58. The audit committee oversees management's procedures for enforcing the company's code of conduct.	0	1	2	3	4	5
59. The audit committee determines that there is a senior-level person designated to understand relevant legal and regulatory requirements.	0	1	2	3	4	5
60. The audit committee oversees the organization's hotline or whistleblower process, reviews the log of incoming calls that relate to possible fraudulent activity, and understands the procedures to prohibit retaliation against whistleblowers.	0	1	2	3	4	5
<b>Monitoring Activities</b>						
61. An annual performance evaluation of the audit committee is conducted and any matters that require follow-up are resolved and presented to the full board.	0	1	2	3	4	5
62. The company provides the audit committee with sufficient funding to fulfill its objectives and engage external parties for matters requiring external expertise.	0	1	2	3	4	5

## For more information

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