

4th Edition

Audit Committee Effectiveness What Works Best

Prepared by



Principal Authors

Catherine L. Bromilow, CPA

Donald P. Keller, CPA

Project Manager

Garret K. Tripp, CPA, CFE

Sponsored by

IIA-Chicago Chapter

IIA-Philadelphia Chapter



Disclosure

Copyright © 2011 by The Institute of Internal Auditors Research Foundation (IIARF), 247 Maitland Avenue, Altamonte Springs, Florida 32701-4201. All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form by any means — electronic, mechanical, photocopying, recording, or otherwise — without prior written permission of the publisher.

The IIARF publishes this document for informational and educational purposes. This document is intended to provide information, but is not a substitute for legal or accounting advice. The IIARF does not provide such advice and makes no warranty as to any legal or accounting results through its publication of this document. When legal or accounting issues arise, professional assistance should be sought and retained.

The Institute of Internal Auditors' (IIA's) International Professional Practices Framework (IPPF) comprises the full range of existing and developing practice guidance for the profession. The IPPF provides guidance to internal auditors globally and paves the way to world-class internal auditing.

The mission of The IIARF is to expand knowledge and understanding of internal auditing by providing relevant research and educational products to advance the profession globally.

The IIA and The IIARF work in partnership with researchers from around the globe who conduct valuable studies on critical issues affecting today's business world. Much of the content presented in their final reports is a result of IIARF-funded research and prepared as a service to The Foundation and the internal audit profession. Expressed opinions, interpretations, or points of view represent a consensus of the researchers and do not necessarily reflect or represent the official position or policies of The IIA or The IIARF.

ISBN 978-0-89413-708-2

6/11

First Printing

Appendix A

Audit Committee Self-assessment Guide

The following guide summarizes leading audit committee practices discussed in this report. You may use it to help assess your audit committee's performance and identify changes to consider in

your processes. Audit committees may also find it beneficial to obtain feedback from management, the internal audit director, general counsel, and the external auditors on committee performance.

Characteristics of Effective Audit Committees	Comments and Follow-up Actions (including any personal plans)
<p>Financial Reporting and Disclosures</p> <p>Your committee: Adequately understands the company's business and the industry in which it operates</p>	
<p>Is satisfied the company adequately addresses the risk that the financial statements may be materially misstated, intentionally or unintentionally</p>	
<p>Understands how management and the external auditors evaluate materiality, both quantitatively and qualitatively, for financial reporting purposes</p>	
<p>Assesses reasonableness and appropriateness of critical accounting policies the company follows, discussing with management and external auditors</p>	
<p>Reviews the reasons for and implications of changes in accounting principles made at management's discretion, understanding stakeholders' potential reaction before approving</p>	
<p>Scrutinizes areas involving management estimates that have a material impact on the financial statements and understands the reasonableness of the underlying assumptions and whether the amount recorded is closer to the conservative or aggressive end of the spectrum</p>	

Characteristics of Effective Audit Committees	Comments and Follow-up Actions (including any personal plans)
<p>Discusses with management <i>substantive reasons</i> for <i>significant changes</i> in the financial statements — between reporting periods and from budget — ensuring <i>explanations</i> are <i>consistent</i> with <i>understanding</i> of the company’s <i>performance</i></p>	
<p>Reviews with management transactions that are <i>unusual, complex</i>, or have increased volume near period ends and their <i>accounting treatment</i>, evaluating <i>appropriateness</i> and <i>consistency</i> with members’ <i>knowledge</i> of the company</p>	
<p>Understands management’s process to identify any significant <i>related party transactions</i> that occur during a reporting period and is satisfied with the related disclosures</p>	
<p>Reads <i>annual financial statements</i>, assessing their <i>completeness and consistency</i> with operational and other information known to members and discussing also with management and the external auditors</p>	
<p>Reviews <i>interim financial statements</i> and related disclosures, understanding consistency with annual reporting, <i>before filing</i> with regulators</p>	
<p>Understands and is comfortable with <i>press releases</i> and other <i>financial information</i> (e.g., earnings guidance, forward-looking information, information for rating agencies) routinely <i>disclosed</i> by the company, including separate reporting of <i>special items</i> or <i>non-GAAP</i> disclosures</p>	
<p>Reads, before publication, <i>narrative reporting</i> and related information, ensuring <i>consistency</i> with <i>financial statements, completeness</i>, and appropriate <i>transparency</i> for issues such as <i>liquidity and financing needs</i></p>	

Characteristics of Effective Audit Committees	Comments and Follow-up Actions (including any personal plans)
Discusses <i>audit results</i> with <i>external auditors</i> , considering management’s handling of corrected or <i>uncorrected misstatements</i>	
Meets periodically with <i>counsel</i> to discuss <i>litigation, claims, contingencies</i> , or other <i>significant issues</i> and their <i>impact</i> on the financial statements	
Understands how management captures <i>all relevant information</i> in the financial statements, including how the <i>management disclosure committee</i> functions	
Reviews any correspondence between the company and <i>regulators</i> regarding financial statement filings and disclosures	
Considers the impact of any identified <i>subsequent events</i> on financial disclosures	
<p><i>Risk Management and the System of Internal Control</i></p> <p><i>Your committee:</i> Is comfortable with the <i>effectiveness</i> of the company’s <i>risk management</i> process</p>	
Clearly <i>understands</i> and agrees with the board on <i>which</i> of the <i>key risks</i> — likely those covering financial reporting and compliance with laws and regulations — <i>it oversees</i> on behalf of the board. Agrees with the board on the <i>specific scope</i> of the committee’s oversight responsibilities for <i>monitoring risks</i> .	

Characteristics of Effective Audit Committees	Comments and Follow-up Actions (including any personal plans)
Reviews the approach to and extent of internal control testing by management , internal audit , and external auditors and how the testing supports any related reporting the company does	
Discusses with management, internal audit, and external auditors their observations , issues , and findings on internal control effectiveness . Understands any significant or material control weaknesses as well as management’s plans to remediate any control deficiencies .	
Reads management’s external reports on the effectiveness of internal control and/or risk management and any related reports from external auditors	
Understands whether compensation incentives could create risk for financial reporting	
Understands any factors that increase financial reporting fraud risk and how management addresses the risk	
Understands the risks of bribery and corruption and how management is minimizing those risks	
<p>Culture and Compliance</p> <p>Your committee: Evaluates the “tone at the top” and the company’s culture, understanding their relevance to financial reporting and compliance</p>	

Characteristics of Effective Audit Committees	Comments and Follow-up Actions (including any personal plans)
<p><i>Understands</i> the effectiveness of the company's <i>programs</i> for ensuring compliance with laws and regulations, considers any significant compliance issues identified, and is satisfied with management's actions</p>	
<p>Ensures management has an appropriate code of conduct. Makes sure that management provides the code, along with related training, to employees and periodically requires employees to certify their compliance.</p>	
<p>Is satisfied that the company's ethics and conduct policies properly address culturally or regionally sensitive issues</p>	
<p>Sees that appropriate support channels are available to help employees address compliance and ethics issues</p>	
<p>Meets periodically with internal audit, general counsel, the compliance officer, and management, among others, to discuss sensitive issues</p>	
<p>Ensures procedures are in place to receive, retain, and address complaints regarding accounting, internal controls, or auditing matters. Considers the potential impact and resolution of any significant issues raised through the whistleblower program.</p>	
<p>Oversight of Management and Internal Audit Your committee: Maintains a productive relationship with management through open lines of communication and candid, continual dialogue, including between committee meetings</p>	

Characteristics of Effective Audit Committees	Comments and Follow-up Actions (including any personal plans)
Strikes the <i>right balance</i> between <i>advising</i> management and <i>monitoring</i> management and is ready to <i>increase</i> its <i>engagement</i> if changes in circumstances warrant	
Ensures management obtains the <i>audit committee's input</i> before making <i>key decisions</i>	
Assesses senior finance management's <i>performance</i> and <i>competence</i> , obtaining feedback from internal audit and external auditors	
Monitors <i>succession plans</i> for the <i>CFO</i> and senior finance team members	
Involves management appropriately in <i>meetings</i> and ensures <i>emphasis</i> on <i>discussion</i> , not presentation	
<i>Meets privately</i> with management on a <i>regular</i> basis	
Builds a <i>trusting relationship</i> with <i>internal audit</i> that includes <i>candid</i> and <i>continual communication</i> between meetings, facilitating ability to raise sensitive issues	
Ensures the role internal audit plays <i>meets</i> the <i>committee's needs</i> for assurance and provides <i>value to management</i>	

Characteristics of Effective Audit Committees	Comments and Follow-up Actions (including any personal plans)
Approves internal audit’s <i>charter</i> and reviews <i>annual plans</i> and any <i>significant changes</i> — ensuring appropriate coverage of risks and coordination of work with external auditors	
Ensures internal audit has <i>adequate resources</i> and <i>budget</i> , including quality and continuity of <i>staff</i> , with ability to supplement skills as needed	
Discusses <i>significant</i> internal audit <i>findings</i> , reported to the committee at an appropriately <i>summarized</i> level, as well as the <i>status</i> of management’s remediation actions	
Ensures internal audit <i>reports directly</i> to the <i>committee</i> , as well as to an appropriately <i>senior position</i> within the company, promoting internal audit’s stature and <i>objectivity</i>	
Plays a <i>central role</i> in <i>appointing</i> or replacing the <i>internal audit director</i> , <i>evaluating</i> his or her <i>performance</i> and <i>determining compensation</i>	
Evaluates internal audit’s <i>performance</i> and operational <i>independence</i> by weighing results of any quality control reviews as well as feedback from management and external auditors	
<i>Meets privately</i> with the internal audit director on a <i>regular</i> basis	
<p><i>Relationship with External Auditors</i></p> <p><i>Your committee:</i> Builds a <i>trusting</i> and <i>professional relationship</i> with external auditors, ensuring <i>open</i> lines of <i>communication</i></p>	

Characteristics of Effective Audit Committees	Comments and Follow-up Actions (including any personal plans)
Drives the <i>selection, oversight, and evaluation</i> of external auditors, obtaining management’s and internal audit’s input and considering replacement when appropriate	
Ensures external auditors’ <i>independence</i> by <i>preapproving</i> audit and nonaudit <i>services</i> , understanding impact of fees, and evaluating type of <i>nonaudit services</i>	
Reviews the <i>external audit scope</i> , understanding <i>risk coverage</i> and significant plan changes	
Receives <i>information required</i> to be <i>communicated</i> under <i>auditing</i> and <i>regulatory standards</i> and seeks insight on how the company’s practices compare to those of peers	
Reviews <i>management’s representation letters</i> to the auditors and inquires about any nonstandard representations	
Understands any <i>disagreements</i> between the auditors and management and determines whether <i>outside advice</i> is needed for <i>resolution</i>	
Understands management’s rationale for <i>using other audit firms</i> for audit work or other services	
<i>Meets privately</i> with external auditors on a <i>regular</i> basis	

Characteristics of Effective Audit Committees	Comments and Follow-up Actions (including any personal plans)
<p><i>What to Do When Things Go Wrong</i></p> <p><i>Your committee:</i> Understands any significant <i>identified errors</i> in previously issued financial statements and agrees with management conclusions regarding the need for <i>restatement</i></p>	
<p>Ensures management conducts a <i>thorough investigation</i> to identify and resolve all errors</p>	
<p>Understands its <i>role</i> and key considerations in overseeing <i>investigations</i> (for possible fraud or illegal acts) and is prepared to <i>take charge</i> when needed</p>	
<p>Has <i>authority</i> and makes the appropriate decision on whether to engage <i>outside advisors</i></p>	
<p>Actively <i>monitors</i> investigation progress and ensures management captures <i>lessons learned</i> and applies them in future investigations</p>	
<p>Is satisfied a <i>crisis management plan</i> exists and enables the company to <i>respond quickly</i> and appropriately to an emerging crisis</p>	
<p><i>Committee Composition</i></p> <p><i>Your committee:</i> Has its <i>new members</i> selected by the <i>nominating committee</i> based on <i>skills</i> and <i>attributes</i> the committee needs</p>	
<p>Considers, with the nominating committee, a need for <i>balancing continuity</i> with <i>fresh perspective</i> when addressing member turnover</p>	

Characteristics of Effective Audit Committees	Comments and Follow-up Actions (including any personal plans)
Has a <i>succession plan</i> for its members and chair	
Has a <i>chair</i> who possesses <i>strong leadership</i> qualities, ability to promote effective discussion and working relationships, and <i>time</i> and <i>financial expertise</i> to direct the committee appropriately	
Has <i>members</i> who <i>possess</i> critical <i>characteristics</i> such as integrity, courage, skepticism, independent judgment, and industry knowledge and have the available <i>time</i>	
Has members who are <i>independent</i> and possess requisite levels of <i>financial literacy</i> and financial <i>expertise</i>	
Is the <i>right size</i> , bringing requisite knowledge, abilities, and skills to the table, yet <i>small enough</i> to <i>act cohesively</i>	
<p>Meetings</p> <p>Your committee: Uses a <i>scheduling calendar</i> to ensure it <i>addresses all</i> its <i>responsibilities</i> over the course of a year, while balancing its workload</p>	
Holds a <i>sufficient number</i> of meetings, <i>scheduled at appropriate points</i> , to address its responsibilities on a timely basis	
Ensures meetings are of <i>adequate length</i> to allow the committee to accomplish its agenda, with <i>time</i> to <i>fully discuss</i> issues	

Characteristics of Effective Audit Committees	Comments and Follow-up Actions (including any personal plans)
Plans meetings properly — with the <i>chair driving</i> the <i>agenda</i> and members providing input	
Is satisfied it receives appropriate <i>advance material</i> for agenda topics, providing the <i>right</i> information and <i>insight</i> , and that material is received in a <i>timely</i> manner and <i>reviewed</i> by <i>members</i> before meetings	
Requires meeting attendance by the <i>right individuals</i> , those with <i>meaningful input</i> on agenda items, and <i>limits</i> the number of <i>observers</i> whose presence may hinder discussion	
Meets in separate <i>private sessions regularly</i> with the <i>CFO, internal audit director</i> , and <i>external auditors</i> and periodically with <i>general counsel, compliance officer, chief risk officer</i> , and other management — allowing <i>full</i> and <i>frank discussion</i> of potentially sensitive matters	
Has members meet <i>regularly</i> in <i>private session</i> , allowing <i>confidential discussion</i> of management’s and auditors’ performance and reflection on other issues	
Communicates effectively with management about issues that arise between meetings, thereby avoiding surprises	
Allows time at meetings for dialogue, with the discussion focusing on relevant topics	
Ensures <i>minutes</i> provide <i>accurate descriptions</i> of meetings, at the <i>right level</i> of <i>detail</i> , and reviews and approves them in a timely manner	

Characteristics of Effective Audit Committees	Comments and Follow-up Actions (including any personal plans)
<p>Reports regularly to the board to discuss activities, key issues, major recommendations, and action plans</p>	
<p>Supporting Committee Effectiveness Your committee: Has a written charter, which has been approved by the board of directors, that it assesses annually for any updates</p>	
<p>Ensures annually that it has carried out all the responsibilities outlined in its charter</p>	
<p>Assesses performance of the committee as a whole annually, taking decisive corrective action and considering improvements</p>	
<p>Evaluates individual members' performance regularly, considering training and other needed support</p>	
<p>Has proper administrative support on an ongoing basis and the authority to engage additional resources when needed</p>	
<p>Ensures new members receive robust orientation to enable them to understand their role and get up to speed quickly</p>	
<p>Ensures that all members have access to continuing education on business and accounting developments and other matters relevant to new responsibilities or changes in the business</p>	