

EFFECTIVE AUDIT COMMITTEES PRIMER

NOVEMBER 2015

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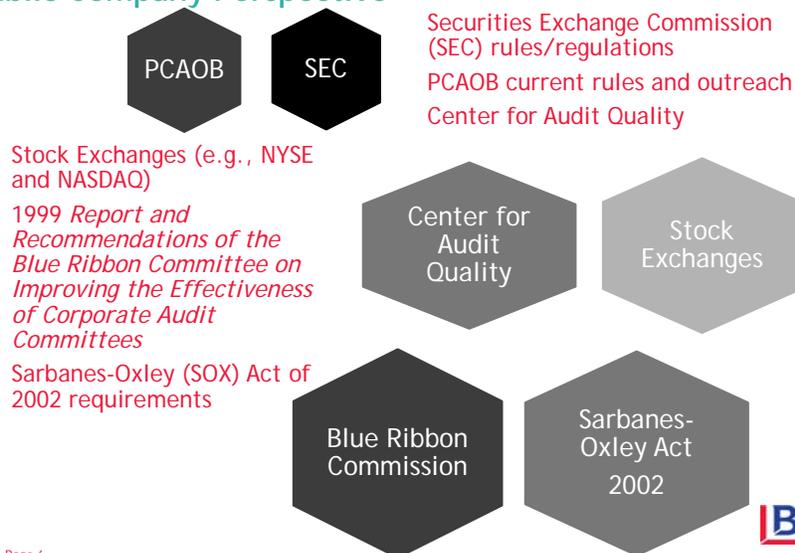
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WHY Are Audit Committees Critical to an Organization's Overall Corporate Governance?

"The audit committee plays an important role in protecting the interests of investors by assisting the board of directors in fulfilling its responsibility to oversee the integrity of a company's accounting and financial reporting processes and both internal and external audits."

SEC Concept Release 33-9862, *Possible Revisions to Audit committee Disclosures*: <https://www.sec.gov/rules/concept/2015/33-9862.pdf>.

WHY Focus on the Audit Committee? Public Company Perspective



WHY Form an Audit Committee?

Private Company Perspective

- Satisfy regulatory requirements (e.g., industry)
- Focus on complexity of accounting rules:
 - Significant standards released/expected - revenue recognition, leases, financial instruments
 - Status of standalone private company GAAP
- Lifecycle/maturation stages
 - Pre/post revenue stages
 - Pre-IPO
 - Selling
 - Expansion
- Aim to provide better financial results and access to capital/transactional markets
- Decision-making for accurate and quality financial reporting
- Ability to build stronger relationships with stakeholders

WHO Should Comprise the Audit Committee?

General Requirements

Minimum of 3 independent and financially literate members*

*At least one member considered a “financial expert”

Independence defined under SOX Section 301 as one:

- Who does not accept any compensation from the company (other than as a director), and
- Is not an “affiliated person” of the company or any subsidiary

Financial expert is a person who has all of the following attributes:

- Understands GAAP and F/S
- Ability to assess general application of principles in connection w/ accounting for estimates, accruals and reserves;
- Experience preparing, auditing, analyzing or evaluating F/S that present a breadth and level of complexity of accounting issues or experience actively supervising one or more persons engaged in such activities;
- Understands internal controls and procedures for financial reporting; and
- Understands the audit committee function

WHO Should Comprise the Audit Committee?

Qualitative Attributes

- Set appropriate **tone** for the organization
- Recognize the **risk appetite** and **tolerance levels**
- Foster good **rapport** between management, the internal auditor, and external auditor
- **Communicate** clear expectations - both internally/externally
- Ask tough questions and follow up on action items
- Able to **react quickly** and **decisively**
- Manage time/resources to address key risks
- Be **transparent** in decision-making
- Demonstrate **requisite knowledge** and **skills** required

WHO Should Comprise the Audit Committee?

Audit Committee Chair

- Strong, independent & competent communicator
- Experienced leader
- Willing to ask tough questions
- Focused on risk management & financial oversight
- Forward thinking
- Has the time to set agendas; conduct both regularly scheduled & special meetings, as necessary
- Can bring & keep all players at the table (“arbitrator”)
- Sets aside time to meet individually with auditors & management to better understand & prioritize matters to be discussed

WHAT Are Responsibilities of an Audit Committee? Statutory Standards (SEC)

- Ensure independence of audit committee members
- Appoint, compensate, retain & oversee the auditor
- Establish procedures for the receipt, retention & treatment of complaints regarding accounting, internal accounting controls, or auditing matters (“*whistleblower*” procedures)
- Authority to engage advisors
- Ensure issuer provides adequate funding to audit committee for carrying out responsibilities

Refer to SEC Practice Section 10A(m) - Standards relating to audit committees (<http://www.sec.gov/rules/final/33-8220.htm>)

WHAT Is the Audit Committee’s Role in Handling Complaints/Whistleblowing?

- The AC must establish procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting controls, or auditing matters, including procedures for the confidential anonymous submission by employees of concerns regarding questionable accounting or auditing matters.
- “*Whistleblower Policy*” should include:
 - Responsibilities of the AC
 - Procedures for receiving and investigating accounting complaints
 - Policy for protecting whistleblowers and ensuring confidentiality
- 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act

WHAT Are Responsibilities of an Audit Committee?

Requirements re: Independent Auditors

- PCAOB Rule and Standard Setting:
 - Rule 3520 - Auditor Independence
 - Rule 3524 - Audit Committee Pre-Approval of Certain Tax Services
 - Rule 3525 - Audit Committee Pre-Approval of Non-Audit Services Related to ICFR
 - Rule 3526 - Communication with Audit Committees Concerning Independence
 - AS 5 - An Audit of ICFR That Is Integrated with an Audit of Financial Statements
 - AS 16 - Communications with Audit Committees
 - AS 18 - Related Parties

WHAT Are Responsibilities of an Audit Committee?

AS 5 - ICFR

- Auditors are required to communicate, in writing and in a timely manner, to the AC all material weaknesses and significant deficiencies that have been identified in the Company's internal control over financial reporting (ICFR).
- Note: In conjunction with the issuance of AS 16, AS 5 has been amended to indicate that required communications to the AC with respect to ICFR should be made in a timely manner and prior to the issuance of the auditor's report on ICFR.
- Other resources:
 - COSO 2013 Internal Control Integrated Framework - <http://www.coso.org/>
 - PCAOB Practice Alert No. 11, Considerations for Audit of Internal Control Over Financial Reporting (November 2013) - <http://www.pcaobus.org>
 - PCAOB Audit Committee Dialogue (August 2015) - <http://www.pcaobus.org>

WHAT Are Responsibilities of an Audit Committee? AS 16 - Communications with Audit Committees

- Expands prior guidance and established requirements to enhance the relevance, timeliness, and quality of communications between the auditor and the audit committee.
- Refer to the BDO AS 16 Practice Aid at: <https://www.bdo.com/insights/assurance/client-advisories/2013-bdo-board-reflections>



WHAT Are Responsibilities of an Audit Committee? AS 18 - Related Parties

- Requires direct inquiries by the auditor to the AC as well as discussion of the auditor's evaluation of the Company's relationships and transactions with related parties and their impact on the F/S
- Refer to BDO's Alert at: <https://www.bdo.com/insights/assurance/flash-reports/assurance-flash-report-november-2014>



WHAT Are Responsibilities of an Audit Committee? Annual Proxy Statement Disclosure Requirements

- Whether company has an AC
- Whether AC members are independent
- Whether AC has a financial expert and who or why there is not
- Number of AC meetings held during the annual period
- Name of any director who attended fewer than 75% board/committee meetings held
- Existence of AC charter
- Functions performed by AC
- Whether AC has reviewed and discussed audited F/S with management
- Whether AC discussed certain matters required by PCAOB with auditor
- Whether audited F/S should be included in company's annual report
- Board's role in risk oversight

Refer to SEC Regulation S-K.T. Item 407 - Corporate Governance

WHAT Are Emerging Trends in Disclosure?

Resources:

- The CAQ /Audit Analytics: *2015 Audit Committee Transparency Barometer (Large-cap, Mid-cap, and Small-cap companies)*
<http://www.thecaq.org>
- SEC Concept Release: *Potential Audit Committee Disclosures* -
<http://www.sec.gov/rules/concept/2015/33-9862.pdf>
- EY Center for Board Matters: *Audit Committee Reporting to Shareholders in 2015 (Fortune 100 Companies)*
[http://www.ey.com/Publication/vwLUAssets/EY-audit-committee-reporting-to-shareholders-in-2015/\\$FILE/EY-audit-committee-reporting-to-shareholders-in-2015.pdf](http://www.ey.com/Publication/vwLUAssets/EY-audit-committee-reporting-to-shareholders-in-2015/$FILE/EY-audit-committee-reporting-to-shareholders-in-2015.pdf)
- James Schnurr, Chief Accountant of the SEC - *Speech to UCI Audit Committee Summit* - <http://www.sec.gov/news/speech/schnurr-speech-uci-audit-committee-summit.html>

WHAT Is the Audit Committee's Role with Respect to Fraud within an Organization?

Oversight responsibility with respect to fraud:

1. Set strong, highly ethical tone at the top that permeates the corporate culture;
2. Ensure proper controls are established to prevent, deter and detect fraud;
3. Exhibit skepticism, a questioning mindset that strengthens professional objectivity, on the part of all participants in the financial reporting supply chain; and
4. Encourage strong communication

When these are in place, the opportunities to commit fraud may be reduced significantly!

WHAT Are Responsibilities of an Audit Committee? Role in the Prevention, Deterrence and Detection of Fraud

1. What are the potential sources of business influence on the accounting staff's judgments or determinations?
2. What pressures for performance may potentially affect financial reporting?
3. What about the way the company operates causes concerns or stress?
4. What areas of the company's accounting tend to take up the most time?
5. What kind of input into accounting determinations does nonfinancial management have?
6. What are the areas of accounting about which you are most worried?
7. What are the areas of recurring disagreement or problems?
8. How does the company use technology to search for an unnatural accounting activity?
9. If a *Wall Street Journal* article were to appear about the company's accounting, what would it most likely talk about?
10. If someone wanted to adjust the financial results at headquarters, how would they go about it and would anything stop them?

Source: CAQ "Deterring and Detecting Financial Reporting Fraud - A Platform for Action"

WHAT Other Areas Are Emerging As Key Areas of Focus for Audit Committees?

- Complex Accounting Standards
- Mergers, Acquisitions, Spin-Offs
- Global Considerations
- Tax Accounting
- Cybersecurity / Data Breaches
- Audit Quality Indicators
- Sustainability
- Anticorruption
- Big Data and Data Analytics
- Current Regulatory Landscape

WHEN Should the Audit Committee Meet?

General rule of thumb:

- At a minimum, meet to plan the External Auditors and at the end to discuss results as well as once per quarter to discuss results of interim reviews
- Additionally, schedule meetings with Internal Auditors at least 2X annually and with other parties as the need arises
- Time allocation should be flexible and committee members should be prepared to meet more frequently as circumstances warrant
- Ensure meeting times correspond with satisfying key responsibilities/ activities outlined in AC charter
- Consider using a matrix/practice aid to document

HOW Should Audit Committee Meetings Be Structured?

General rule of thumb:

- Meetings should include executive sessions with both IA/EA, without management present, as often as necessary
- Agendas for meeting should be prepared by AC chair with appropriate input from others
- Pre-read materials should include high level summaries with supporting material included - highlighted, if possible, for areas of focus
- Materials should be reviewed in advance to allow ample time for discussion of sensitive issues

HOW Does An Audit Committee Prepare A Meaningful Charter?

- Adopt a formal, written **charter** approved by the board and reviewed by audit committee on an annual basis outlining the oversight mission:
 - **Financial reporting** - conduct and integrity of financial reporting
 - **Risk management** - inclusive of internal accounting and disclosure controls
 - **Audit function** - oversight of and communication with independent auditors
- Should **NOT** be a "*check the box*" type of document
- Should include:
 - Mission
 - Scope of specific responsibilities
 - How responsibilities are to be carried out
 - Membership requirements
- Should be routinely reviewed and updated

Refer to BDO Illustrative Audit Committee Charter:
<https://www.bdo.com/insights/assurance/client-advisories/illustrative-audit-committee-charter>

HOW Should the Audit Committee Interact with the Full Board?



HOW Should An Organization Determine The Audit Committee Is Functioning Effectively?

- Conduct an **annual assessment** that includes action steps
- Assessment should be used in conjunction with AC charter to ensure governance responsibilities are adequately aligned and are being fulfilled
- Examples of specific assessment topics may include:

Composition and character	Oversight and ICFR
Role of the chairperson	Evaluation of communications with management and auditors
Independence, ethics, and code of conduct	Financial statements and other information
Continuing education	Authority and funding
Setting tone at the top	

Refer to BDO Audit Committee Self-Assessment Tool at:

<https://www.bdo.com/insights/assurance/client-advisories/audit-committee-self-assessment>

HOW Can an Audit Committee Learn More To Remain Engaged on Governance Developments?

- Schedule time with auditors to highlight issuance of new accounting and reporting standards and other “hot topic” areas
- Attend continuing education programs aimed at those charged with governance and financial executives
- Request sessions with financial AND operational management, as well as others within the organization, to truly understand the company’s business and risks
- Read minutes of other committees of the boards
- Review industry analysis and trends
- Focus on relationship building across organizations

Resources

BDO Resources On the Horizon

- Launch of the **virtual** BDO Corporate Governance and Financial Reporting Center of Excellence
- 2016 Edition: BDO Effective Audit Committee Publication and related practice aids and tools*

*Current versions are available on the Insights page at:
<https://www.bdo.com/>

Sample Governance Resources

- Audit Committee Charter
- Audit Committee Resolutions re: Year-End Matters
- NASDAQ Director Independence and Committee Qualifications Checklist (includes SEC and NASDAQ requirements for Audit, Compensation and Nominating Committees)
- NYSE Director Independence and Committee Qualifications Checklist (includes SEC and NYSE requirements for Audit, Compensation and Nominating Committees)

Available upon request: LRockett@mintz.com

BDO Board Governance

Additional resources accessible via [BDO Board Governance](#):

<https://www.bdo.com/services/assurance/board-governance/overview>

Recent BDO Publications:

- CAQ Issues 2015 Audit Committee Transparency Barometer
- SEC Adopts Rule for Pay Ratio Disclosure
- Continuous Monitoring
- Q2 2015 Significant Accounting and Reporting Matters
- SEC Proposed Rules Requiring Clawback of Executive Compensation
- 2015 BDO IPO Halftime Report
- SEC Issues Concept Release Seeking Comment on Possible Revisions to Audit Committee Disclosures
- PCAOB Audit Committee Dialogue and Other Resources
- PCAOB Issues Proposals to Improve Transparency and Provide Insight Into Audit Quality
- SEC Adopts Amendments to Regulation A
- External Auditor Assessment Tools
- Audit Committee Disclosure Resources
- SEC Proposal on Pay vs. Performance Disclosures
- FASB ASU on Going Concern
- PCAOB AS 18 - Related Party Transactions
- Center for Audit Quality Approach to Audit Quality Indicators

For a complete listing of BDO publications, refer to: <https://www.bdo.com/insights/>



BDO Board Governance

Upcoming BDO Governance and Financial Reporting Knowledge Webinars:

- Quarterly Technical Update (Q4 2015)* - January 7, 8 and 11

*Registration will be available shortly on <https://www.bdo.com/events>

Recent Archived Webinars:

- Establishing an Effective Internal Audit Function* - October 2015
- The Board's Role in Anticorruption Compliance - October 2015
- Revenue Recognition Transition Resource Group 2015 Update - September 2015
- Quarterly Technical Update (Q2 2015) - July 2015
- How ASU 2015-02 Changes Consolidation Accounting - May 2015
- Data Analytics and Risk Management - A Board Primer - April 2015
- 2015 Q1 Technical Update - April 2015
- 2015 Executive Pay Outlook for Mid-Cap Companies - March 2015
- What's On the Minds of Boards - January 2015



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- ▶ **Board Governance** — Resources that include BDO's proprietary studies, publications, practice aids, and educational programs to keep board members of both public and private companies up to date on emerging issues and trends to assist in fulfilling their corporate oversight responsibilities. Such resources contain customized information for the various committees of the board. For example, refer to our Effective Audit Committees in the Ever Changing Marketplace practical guide and related tools. Visit our Insights page on <http://www.bdo.com>.
- ▶ **Significant Accounting and Reporting Matters Guide** — Quarterly digest of final and proposed financial accounting standards designed to help audit committees, boards and financial executives keep up to date on the latest corporate governance and financial reporting developments.
- ▶ **Client Advisories** — Concise documents that provide timely commentary, analysis and insights on events and trends of interest to management and boards of directors.



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- ▶ **Technical Research Tools** — BDO uses Accounting Research Manager™ (ARM) as a primary source of insightful interpretations on GAAP, GAAS and Securities and Exchange Commission rules. ARM is updated daily and is considered to be one of the timeliest and most comprehensive online databases of analytical interpretations of accounting, auditing and SEC matters. Access to ARM, and a number of other research tools, provides each professional the technical research capability to respond immediately to client-specific technical issues.
- ▶ **BDO Knows Flash Reports** — Provide briefs about select technical and regulatory developments and emerging issues are made immediately available to BDO professionals and to clients.
- ▶ **BDO Knows Financial Reporting Letters** — Provide more in-depth discussions and practical guidance on technical guidance affecting both public and private entities.
- ▶ **Industry Newsletters, Alerts, Reports, Proprietary Studies and Surveys** — A variety of publications depicting specific industry issues, emerging trends and developments.
- ▶ **BDO Knowledge Webinar Series** — An educational series designed to assist those charged with governance (e.g., Audit Committees) and financial executives in keeping up to date on the latest corporate governance, risk management and financial reporting developments. The program is multi-faceted and consists of complimentary CPE webinars and archived self-study courses, covering both broad and specific topics of interest, publications and links to various BDO and external resources.

Additionally, consider our monthly tax series that provide insights and perspectives on the tax issues most important to our clients and their businesses. Visit our Event/Webinar page for a current listing of programming on <http://www.bdo.com>.



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Conclusion

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