



EFFECTIVE AUDIT COMMITTEES IN THE EVER CHANGING MARKETPLACE

Accsense

n. **1. BDO's** program designed to help financial executives and those charged with governance (e.g., audit committees and board members) keep up to date on the latest corporate governance and financial reporting developments. **adj. 2. Accented** service received year-round from BDO to keep you in the know.

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To ensure compliance with Treasury Department regulations, we wish to inform you that any tax advice that may be contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding tax-related penalties under the Internal Revenue Code or applicable state or local tax law provisions or (ii) promoting, marketing or recommending to another party any tax-related matters addressed herein.

Material discussed in this publication is meant to provide general information and should not be acted on without professional advice tailored to your individual needs.



While geared primarily toward audit committees of public entities, much of the content included within is applicable to those charged with governance of private entities as well. Where appropriate, we have provided additional guidance/considerations specifically for private entities throughout this publication.

► PREFACE

The Sarbanes-Oxley Act ("the Act") of 2002, Securities and Exchange Commission (SEC) regulations, stock exchange rules, along with escalating media attention on corporate governance and financial reporting issues have impacted the marketplace for companies, those charged with governance, and specifically for audit committees. More recently, globalization of financial reporting, financial crises, economic downturn, corporate fraud and a variety of other matters have brightened the spotlight on the governing of business. More than ever, there is a prevailing belief that effective audit committees are essential to the development and maintenance of efficient and effective capital markets. To that end, BDO continues the tradition of assisting those charged with governance (including audit committees, boards of directors and financial executives) via our outreach program called **Ac'senseSM**.

As background, the Act required the SEC to adopt rules to implement a number of the Act's provisions. In connection with its rulemaking, the SEC has directed the national securities exchanges and associations to prohibit the listing of the securities of an issuer that is not in compliance with the standards for audit committees as set forth in the Act. The SEC's rules, together with rules adopted by the exchanges, set minimum standards for the independence and credentials of audit committee members and require audit committees to be directly responsible for the appointment, compensation, retention, and oversight of the work of a company's auditors. In addition to conforming to these rules and regulations, audit committees are further challenged to meet the high expectations of company shareholders that have entrusted them with governance.

The focus of **Ac'senseSM** is to provide those charged with governance with essential, relevant information through clear and concise executive summary-type communications. In this spirit, we have updated this practical guide to forming and running an effective audit committee, in which we provide answers to certain frequently asked questions (FAQs) centering on the WHYS, WHOs, WHATS, WHENs and HOWs of audit committees. More specifically, these FAQs summarize the common functions and responsibilities of audit committees and seek to provide insight and perspective as to how to optimize audit committee effectiveness. Our vision has been shaped by our own experiences with our clients and interpretations of the specific recommendations, guidelines and rules of the SEC; the stock exchanges; the Public Company Accounting Oversight Board (PCAOB)¹; the American Institute of Certified Public Accountants (AICPA); the Blue Ribbon Committee on Improving the Effectiveness of Corporate Audit Committees, sponsored by the New York Stock Exchange and the National Association of Securities Dealers; along with guidance issued by the Center for Audit Quality (CAQ) and the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Throughout this guide, we focus on some of the more challenging aspects facing audit committees. To that end, in addition to our commentary, we have included links and references to other relevant BDO practice aids and tools as well as certain valuable external resources. We hope you will find this guide and its links helpful in understanding and meeting the many requirements and challenges of the **ever changing marketplace** for those charged with governance and more specifically, for audit committees.

The Sarbanes-Oxley Act, SEC regulations, stock exchange rules, escalating media attention on corporate governance and financial reporting issues... a variety of matters have impacted the marketplace for companies and specifically for audit committees...at BDO, we have created an outreach program called Ac'senseSM to assist those charged with governance with the increased demands placed on them as a result of recent developments and ongoing challenges.



▶ THE WHYS

WHY ARE AUDIT COMMITTEES SO IMPORTANT TO AN ORGANIZATION'S OVERALL CORPORATE GOVERNANCE?

The current environment has heightened the need for effective audit committees. The financial debacles and alleged fraudulent activities at established companies along with phenomena such as the credit crunch and continuing economic turbulence are well known to the public. Young, growing companies also face a unique set of challenges triggered by their less-developed internal control structures. As a result, both established companies as well as emerging companies have an even greater need for independent oversight.

A study released in 2010 by COSO concluded that fraud is NOT limited to companies of a certain size and found that companies charged with fraudulent reporting by the SEC included startups with no assets or revenues, as well as much larger companies.²

Today's marketplace has shifted the focal point for governing bodies from simply overseeing company operations to assessing company strategies and risk management processes, understanding complexity and being prepared to handle crises. We will explore all of this in more detail in the following pages.

The SEC defines an audit committee as "a committee (or equivalent body) established by and among the board of directors of an issuer for the purpose of **overseeing** the accounting and financial reporting

processes of the issuer and audits of the financial statements of the issuer..." To be listed, the major stock exchanges (NYSE, NYSE AMEX, and NASDAQ) all require that companies maintain independent audit committees.

Under the COSO internal control framework, "**the control environment** sets the tone for an organization. It is the foundation for all other components of internal control, providing discipline and structure."³ A key element of the control environment is the "**tone at the top**," the message from the highest levels of the organization regarding the ethical and compliance behaviors of management and employees. We believe that for an audit committee to truly exercise proper oversight, it must influence the tone at the top. Key steps that the audit committee should take in this direction include the following:

- Ensure management clearly communicates to all employees that financial misreporting is absolutely unacceptable
- Insist on receiving all news, especially bad news, promptly and fully
- Ask tough questions
- Be skeptical
- React quickly to issues and take preventive measures for the future

▶ BDO INSIGHT

A strong audit committee is important for all companies. Growing companies, as well as established companies benefit from the experience, oversight and direction that an audit committee may provide.

WHY SHOULD A PRIVATE COMPANY CONSIDER FORMING AN AUDIT COMMITTEE?

Many large, complex private companies have formed audit committees simply because investors view such committees as an integral and essential part of corporate governance to manage the business and often, to deal specifically with the complex accounting rules that exist under U.S. generally accepted accounting principles ("GAAP"), and the unprecedented changes that are expected in the future as it relates to both U.S. GAAP and International Financial Reporting Standards ("IFRS"). Other organizations, including not-for-profit entities, have done so as a result of specific industry regulations or in preparation for going public at some point in the future. The AICPA's *Audit Committee Toolkit for Private Companies*⁴ lists numerous reasons as to why a private company should consider forming an audit committee, including providing better: financial results and access to capital; decision-making in terms of accuracy and quality of financial reporting; ability to build stronger relationships with stakeholders; as well as facilitating transitions in leadership and in entering public capital markets.

First, let's consider the application of U.S. GAAP. While the debate over the appropriateness of one set of financial accounting standards used by companies of all sizes and complexities has been going on for years, there is growing sentiment within the U.S. in support of a separate, standalone set of accounting standards for U.S. private companies. To that end, in December 2009, a Blue Ribbon Panel charged with making recommendations on the future of standard setting for private companies was launched by the AICPA and the Financial Accounting Foundation ("FAF" – the parent organization of the Financial Accounting Standards Board ("FASB")). A report from the Blue Ribbon Panel is anticipated within the next year and BDO is following the activity of the panel quite closely. With this potential shift in the accounting and disclosure model, emphasis on the oversight of application of new standards as well as on the changes to be made related to procedures and controls will be required by those charged with governance to ensure the reliability and objectivity of financial reporting.

Second, while the formation of the Blue Ribbon panel is intended to address U.S. GAAP issues, let's consider the inroads IFRS are beginning to make on private companies. In 2008, the AICPA recognized the International Accounting Standards Board ("IASB") as an official standard-setter and thus, U.S. auditors are now permitted to issue opinions on private company financial statements filed using IFRS, as recognized by the IASB. More recently, in July 2009, the IASB published a 230-page condensed version of IFRS for small and medium-sized entities: "*IFRS for SMEs*." The IASB defines *SMEs* as businesses that publish general-purpose financial statements for external users and do not have public accountability. *IFRS for SMEs* was developed for private companies and their financial statement users as a simplification to full IFRS. You may refer to BDO's [IFRS Resource Center](#) for further information as well as a link to BDO's *Ac'sense IFRS vs. IFRS for SMEs* archived webcast at: <http://www.bdo.com/ifrs/>.

Given this increased activity aimed at "simplification" of accounting standards for private companies, encompassing both U.S. GAAP and international standards, it is easy to understand how having a focused

The Blue Ribbon Panel on Standard Setting for Private Companies is composed of a cross section of financial reporting constituencies: lenders, investors, owners, preparers, auditors and regulators.

The Panel has been charged with a comprehensive review of the current system of standard setting for private companies in the U.S., with a focus on the following matters:

- Who are the actual users of private company financial statements and how do they use GAAP financial statements in their decision making?
- What is the key, decision-useful information that the various users need from GAAP financial statements?
- Are current GAAP financial statements meeting those needs? Why or why not?
- Are the benefits of GAAP financial statements outweighing the costs of preparing those statements for private companies?
- How does standard setting for private companies in the U.S. compare to standard setting in other countries, both those that have adopted *IFRS for Small and Medium-Size Entities* (see below) and those that have not?
- To the extent that current GAAP is not meeting user needs in a cost-beneficial manner, what are some possible alternatives for private company standards (e.g., separate, stand-alone standards; base-level standards for all entities with additional disclosure requirements for public companies) and what are the implications for standard-setter structure and/or processes?

In addressing these matters at a strategic level, the Panel will consider relevant studies and other reports on private company financial reporting that have been done over the years by the AICPA, the FAF, and others. Their primary focus is selecting a model for private company financial reporting that is relevant to the users of private company financial reports. The Panel has scheduled five general public forums through December 2010. Refer to: <http://www.fasb.org/home>.

“Though still well below 2007 ‘pre-crisis’ levels, in predicting an increase of 25% for U.S. IPOs in 2010, the BDO IPO Outlook survey revealed broad-based optimism among the capital markets community that offering activity...will build on momentum established in the past year.”

– Christopher Tower, Partner, BDO USA, LLP

oversight function by means of an audit committee in place to ensure that an entity’s decision-makers are remaining abreast of developments in financial reporting may be critical.

Third, let’s consider the optimism in the initial public offering (“IPO”) and mergers and acquisitions (“M&A”) markets. According to a survey of 100 executives at leading investment banks performed by BDO’s [Capital Markets Practice](#) earlier this year, [The 2010 BDO IPO Outlook Survey](#), approximately 68% believed that IPO activity would increase in 2010 as compared to 2009. Support for this is evident in the number of U.S. IPOs actually completed through November 15, 2010: 124 priced IPOs as compared to 63 in total for 2009.⁵ While the outlook for 2011 of course remains dependent upon the strengthening of the global economy, according to investment bank Renaissance Capital, the Q3 2010 IPO pipeline had 170 companies poised to go public with a shift in demographics from the finance and energy sectors to a higher number of filings from venture capital-backed firms in the technology and healthcare sectors.⁶ Companies considering an initial public offering will need to weigh significant factors. One of those factors is that a newly public company will be required to meet significant corporate governance requirements. Establishing a governance team early on in the IPO process will aid in easing the transition into the public eye. For further insights into taking a company public, please refer to the [BDO Guide to Going Public](#) available on our [IPO Readiness Center](#) website at: <http://www.bdo.com/ipo/>. A recent survey of 150 executives of firms ranging from small regional businesses to \$200 billion conglomerates, conducted by Thomson Reuters and Freeman Consulting Services⁷, appears to indicate a “positive outlook” with a forecast of global M&A volume to grow by a third and anticipated equity capital market activity to increase over 20% during 2011.

Finally, it’s all in the eye of the beholder. Consider perceptions of corporate governance and the potential effects on transactions and proceedings involving a company (e.g., significant customer/vendor relations, mergers, dispositions, acquisitions, raising capital, bankruptcy, litigation, etc.). Simply, companies that are perceived to have solid governance structures and practices are looked upon more favorably than those that do not.

►BDO INSIGHT

While much attention is paid to public companies, private companies can also benefit from the assistance, guidance and oversight an audit committee can provide. Thus, absent specific requirements to maintain an audit committee, we encourage management, owners and boards to weigh the benefits and costs of establishing audit committees within their organizations. In doing so, we recommend a thorough reading of this and other related guidance to understand what the decision to form and run an effective audit committee really means to the company. A company’s future liquidity plans may be a key factor in this decision-making process. A company with an established governance body becomes even more attractive to risk-adverse lenders, investors and potential buyers. Furthermore, experience has shown us that the establishment of an audit committee prior to going public will allow an Initial Public Offering (IPO) candidate to avoid the mad scrambling to fill the audit committee positions at the “11th hour” and provide potential shareholders with additional confidence derived from the emphasis placed on a strong corporate governance structure by the organization.



▶ THE WHOS

BEFORE WE GET INTO THE “WHOS” OF THE AUDIT COMMITTEE IN PARTICULAR, WE SHOULD ENSURE THAT WE RECOGNIZE THE KEY PARTICIPANTS WITHIN THE MARKETPLACE, AS THEY ALL BRING UNIQUE EXPERIENCES AND PERSPECTIVES TO THE GOVERNANCE OF FINANCIAL REPORTING.

Let's begin with participants within the companies themselves, which include the oversight boards and directors; financial and operational management; and internal auditors. Independent external auditors play a pivotal role in providing assurance as to the reliability of the financial statements prepared by management. Consultants and third party advisors, such as legal counsel, also play key roles in assisting the companies to navigate the rules and regulations of the marketplace, which include key operational and financial reporting aspects.

External to the company are the regulatory agencies (the SEC, PCAOB and governmental organizations); standard-setters (FASB, AICPA, IASB, etc.); and financial analysts, all of whom are actively concerned with the structuring and protection of fair and consistent reporting within the marketplace for all companies.

Shareholders, investors and suppliers, along with the media, are also viewed as key participants as they continue to gain more and more power in shaping how business is transacted and communicating how companies should be governed.

The interaction of all of these participants is what makes business so intriguing and as of late, decidedly more challenging. The ever changing conduct and governance of business demands that these various participants and stakeholders work together to promote the reliability of the financial reporting process.

At the center of this **ever changing marketplace** is the audit committee, in its oversight role, who is charged with fostering the appropriate tone at the top and establishing and maintaining strong relationships with the other key participants.

Let's now explore this responsibility more closely...

WHO MAKE THE BEST AUDIT COMMITTEE MEMBERS?

The best audit committees are those who set the appropriate **tone at the top** where the focus is on ensuring the organization acts in accordance with the best interests of its investors and the public at large. Fundamentally, this can only occur in environments where in-depth knowledge, integrity and an unbiased perspective pervade and are brought to bear at the board and audit committee, senior management and leadership levels. These members not only bring a wealth of industry, general business and financial knowledge and experience to the table, but also can very effectively apply such knowledge and experience to the organization's specific circumstances. This entails **knowing the organization and its risks**, which is fostered through **regular involvement and communications** with management and the internal and external auditors. The best audit committee members demonstrate a high level of involvement and engage in frequent communications, ensuring that a **two-way constructive dialogue** occurs at all times whereby appropriate information- and knowledge-sharing takes place between all parties involved.

Furthermore, it is imperative that the expectations of the audit committee as a governing body are understood and actions are appropriately carried out. For example, the best audit committees will take an active role in identifying financial statement areas where, given the particular circumstances, the committee may require incremental procedures to be performed by the internal or external auditors. The audit committee is also highly involved in the organization's financial reports, ensuring that presentation and disclosure matters of significance are handled fairly and transparently. Such an audit committee realizes its role in initiating communications, creating meeting agendas and following up on the results of actions taken. We will discuss these and other best practices in more detail throughout this publication.

There are numerous requirements specified by the various rulemaking bodies (SEC, stock exchanges, etc.) with respect to audit committee membership. These requirements largely focus on **independence** and **credentials**. All the major U.S. exchanges require that audit committees be comprised of a minimum of three independent, financially literate members.⁸ In addition, each of the exchanges requires that at least one member possess additional financial expertise.

Let's look at these requirements more closely...

Independence

The major stock exchanges require that audit committee members be independent of the companies they serve. Under Section 301 of the Act, an independent director is defined as one:

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

THE AUDIT COMMITTEE'S RELATIONSHIPS



A more detailed discussion of the independence requirements, including certain exceptions, can be found in BDO's Financial Reporting Letter "SEC Completes Mandated Sarbanes-Oxley Act Rulemaking" at: <http://www.bdo.com./publications/assurance/finrptnl/FRL-SECRules7-03-4.pdf>. In addition, the *Report of the NACD Blue Ribbon Commission on The Audit Committee*⁹ contains a table within its appendices that lays out the various requirements of the Act along with those of the NYSE and NASDAQ as well as the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act.

"True" Independence vs. "Legal" Independence

While the SEC and the exchanges offer rule-based definitions of independence, audit committees are best served by members that truly maintain an attitude of independence. Such members should be without bias with respect to the company. More specifically, the audit committee must be able to resist management's attempts at compromising financial reporting.

"[Audit Committees'] views are critical because of the essential role they play in overseeing the production of corporate financial statements and the work of public company auditors."

– Cindy Fornelli, Executive Director of the Center for Audit Quality (CAQ)

►BDO INSIGHT

We believe that the guidance on independence for auditors contained in the PCAOB's Auditing Standards (AU) Section 220 *Independence* can be applied to audit committee members as well. To paraphrase, independence does not imply an attitude of a prosecutor but rather a judicial impartiality that recognizes an obligation for fairness not only to management but also to shareholders, creditors, and those who may otherwise rely on the financial statements.

Refer to the **WHAT** section for specific audit committee responsibilities with respect to continued independence.

WHO CAN SERVE AS A FINANCIAL EXPERT ON THE AUDIT COMMITTEE?

Listing standards require the following with regard to general financial literacy:

- NYSE – Audit committee members must be financially literate, as determined by the board of directors, or must become financially literate within a reasonable period of time following their appointment.
- NASDAQ – Audit committee members must be able to read and understand financial statements at the time of appointment.
- NYSE AMEX – Audit committee members must be able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement or will be able to do so within a reasonable period of time following their appointment.

Furthermore, the Act requires all companies whose securities trade in the U.S. to disclose in its annual reports whether or not the audit committee includes at least one member who is an "audit committee financial expert" and, if not, the reasons.

The SEC defines an audit committee financial expert as a person who has all of the following attributes:

- An understanding of generally accepted accounting principles (GAAP) and financial statements (with respect to foreign private issuers, the understanding must be of the GAAP used by the foreign private issuer in preparing its primary financial statements);
- The ability to assess the general application of such principles in connection with the accounting for estimates, accruals, and reserves;
- Experience preparing, auditing, analyzing, or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;

- An understanding of internal controls and procedures for financial reporting; and
- An understanding of the audit committee function.

Further, the SEC requires that a person must have acquired these attributes through any one or more of the following:

- Education and experience as a principal financial officer, principal accounting officer, controller, public accountant, or auditor, or experience in one or more positions that involve the performance of similar functions;
- Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor, or person 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; or
- Other relevant experience.

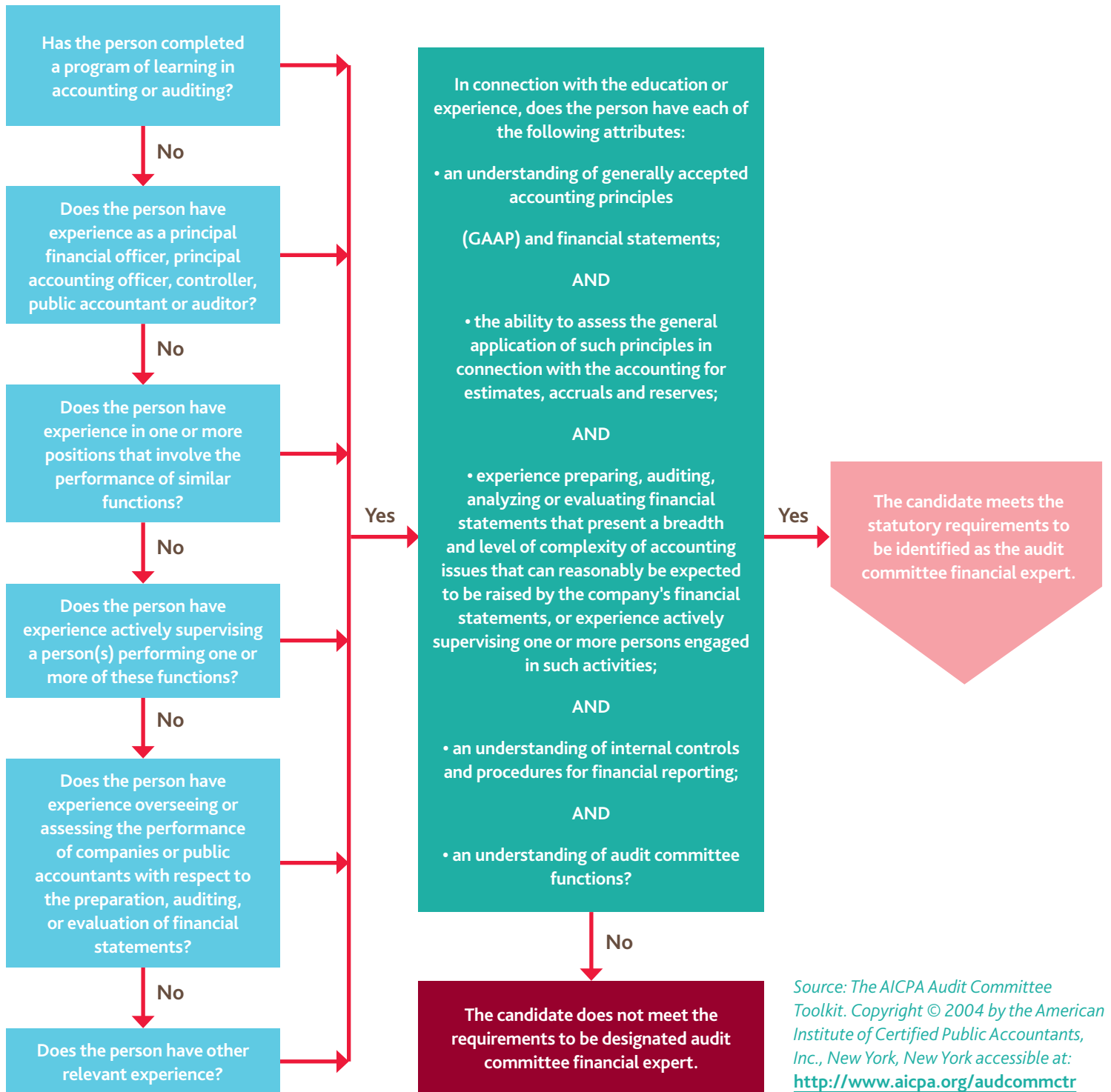
The responsibility to determine whether a person qualifies to be treated as an audit committee financial expert, based on the rules discussed previously, rests with the board of directors.

To be listed on an exchange, each exchange has requirements for financial expertise that differ slightly from those of the SEC. They are summarized as:

- **NYSE:** At least one member of the audit committee must have "accounting or related financial management expertise" in the judgment of the board.
- **NYSE AMEX:** At least one member of the audit committee must have had past employment expertise in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer, or other senior officer with financial oversight responsibilities. (This requirement does not apply to "smaller reporting companies.")
- **NASDAQ:** At least one member of the audit committee must have had past employment in accounting or other comparable experience or background such as being or having been a chief executive officer, chief financial officer, or other senior official with financial oversight responsibilities, that results in the individual's financial sophistication.

Despite the differences noted here, all of the exchanges specify that a director who meets the SEC's definition of an audit committee financial expert possesses the necessary acumen to meet their expertise requirements.

THE AICPA'S AUDIT COMMITTEE TOOLKIT CONTAINS THE FOLLOWING DECISION TREE THAT MAY ASSIST AUDIT COMMITTEES IN EVALUATING A CANDIDATE FOR CONSIDERATION AS THEIR FINANCIAL EXPERT:



Source: The AICPA Audit Committee Toolkit. Copyright © 2004 by the American Institute of Certified Public Accountants, Inc., New York, New York accessible at: <http://www.aicpa.org/audcommctr>

► **BDO COMMENTARY:** If, upon reaching the bottom of the left column of the flow chart, all of the answers to the preceding questions are "NO," then the candidate would not meet the requirements to be designated as an audit committee financial expert. "Statutory requirements" within the pentagon on the right of the flowchart indicates statutory requirements of the SEC.

“Akin to assembling a Board, whose members have diverse backgrounds, building an audit committee with differing and broad financial expertise and experiences may serve to enhance the analysis, review and ultimately, the controls over the organization’s financial reporting.”

– Peter Tombros, Chairman of the Board of Directors of NPS Pharmaceuticals, Inc.

WHY DO AUDIT COMMITTEES NEED TO INCLUDE A FINANCIAL EXPERT?

- Established rules equate to elevated responsibility and risk for audit committees.
 - The audit committee is required to formally recommend to the board that the audited financial statements be included in the Form 10-K. In addition, the external auditors are required to discuss with the audit committee the auditors’ judgment about the quality, not just the acceptability, of the company’s accounting principles. Moreover, auditors are required to communicate significant issues identified to the audit committee in conjunction with 10-Q filings. The audit committee must be active in asking knowledgeable and probing questions about these matters and not merely listen to presentations by the auditors and management.
- Business transactions are increasingly complex, making it difficult to understand the proper accounting treatment or related economic risks.
 - Generally, an individual that has past experience in finance and accounting along with the requisite industry knowledge can be a crucial and invaluable addition to the audit committee.
 - The body of accounting rules and complexity of such rules is increasing dramatically, with pending convergence to one set of world-wide acceptable accounting standards (i.e., IFRS), coupled with the SEC’s continued efforts to detect signs of earnings management.*

* Note: For upcoming and archived **Ac’sense**SM complimentary webinars focusing on financial accounting and reporting developments, including topics on IFRS, please refer to: <http://www.bdo.com./acsense/>.

We are all acutely aware of the accounting and disclosure complexities faced by companies today. This issue is only going to become increasingly more challenging as the FASB and IASB continue to set aggressive agendas for release of new standards. They recently affirmed June 2011 as the target date for completing several major projects

toward international convergence. The number of expected major changes is unprecedented and causes great concern that such changes will consume significant amounts of management time and will carry a high risk of mistakes. Companies will be expected to disclose the impact of these changes and audit committees will need to “get up to speed” quickly on changing accounting rules that cover a broad range of matters from revenue recognition to accounting for leases. For IASB and FASB project updates, refer to <http://www.ifrs.org/Home.htm> and <http://www.fasb.org/home>, respectively.

Coupled with the release of complex technical accounting and reporting guidance is the expectation of more transparency in disclosure by regulators and investors. For example, the SEC’s Division of Corporation Finance has utilized the practice over the past several years of issuing what are being termed as “Dear CFO” letters. These are sample illustrative letters sent to public companies identifying certain disclosures that the companies “may wish” to consider in preparing their Management’s Discussion and Analysis (MD&A) with respect to such topics as the application of fair value, disclosure of the provisions and allowances for loan losses, potential risks and costs associated with mortgage and foreclosure-related activities or exposures, investments in certain investment vehicles (e.g., repurchase agreements and other transfers of financial assets) as well as certain off-balance sheet investments (e.g., non-consolidated conduits and collateralized debt obligations). In September 2010, the SEC issued interpretive guidance with respect to the presentation of liquidity and capital resources within MD&A, specifically focused on liquidity trends and uncertainties.¹⁰ Additionally, the SEC Staff has made public specific observations with respect to its review of the application by 350 public companies of the enhanced executive compensation disclosures within the required Compensation Discussion and Analysis (CD&A). The Staff has indicated that it expects companies to specifically disclose how and why a company arrives at specific executive compensation decisions and policies and do so in a manner of presentation that is easy to understand. Refer to <http://www.sec.gov/divisions/corpfin/cfdisclosure.shtml>.

A recent survey was performed by the CAQ¹¹ to ascertain the shared views of audit committee members from small-, medium- and large-cap companies as to the quality of the audit process since the passage of the Act. Of the 253 participants, approximately 24% were designated

financial experts. Several of the questions in the survey dealt with how the role of audit committee members has changed. In particular, over 80% indicated that the level of specialized knowledge required to perform their job has increased (either somewhat or significantly). Additionally, approximately 66% indicated that the designation of a financial expert on audit committees had a (either somewhat or very) positive impact on the overall quality of audits of public companies.¹²

►BDO INSIGHT

We believe boards need to assess the specific and unique circumstances and experiences of the companies they serve in selecting candidates for service on committees of the board. The selection of audit committee members, and particularly the decision regarding whether to include more than one financial expert, must take into account various factors, including weighing the risks and complexities of the financial reporting of the company as well as the current composition of the audit committee, along with careful consideration of its strengths and perceived weaknesses. The board needs to consider the broad experiences – financial, industry, leadership, etc. – that potential candidates bring to the table and financial expertise is one of many attributes that need to be weighed. Furthermore, in considering whether an audit committee should have an “accountant” in the mix is dependent on the types of experiences that all members, as a group, bring to the table. However, experience in accounting matters and the propensity to remain current in the increasingly complex and mounting accounting technical literature are attributes that should be weighed heavily in the candidate selection process.

Liability of Financial Experts

A safe harbor is included within SEC Regulation S-K making it clear that an audit committee financial expert is not deemed an “expert” under Section 11 of the Securities Act or for any other purpose. In addition, an audit committee financial expert has no greater obligations or liability than the members of the audit committee and board of directors who are not designated as financial experts, and the presence of an audit committee financial expert does not reduce the other members’ obligations or liability. However, we advise audit committee members to seek advice from legal counsel on questions of legal liability.

WHO SHOULD FILL THE ROLE OF THE AUDIT COMMITTEE CHAIR?

The role of the audit committee chair is without question a demanding one. This role requires a strong, independent and competent communicator who is willing to **ask tough questions** of management and others in order to truly understand and ensure that the audit committee is **focused on risk management and financial oversight** of the company and that the company’s strategic direction is in line with reality. The audit committee chair should be financially literate.

This is not to say that the audit committee chair needs to be the financial expert of the committee, but more often than not this may be the case. In addition to being financially literate, a chair should be an experienced leader who can be forward-thinking and have the time to set agendas and conduct both regularly scheduled and special meetings, as necessary, that effectively involve all of the key participants (management, auditors, and the board) and get to the heart of corporate governance and financial reporting matters.

►BDO INSIGHT

A best practice that we continue to see is the audit committee chair setting aside the time to meet individually with the external auditors, internal auditors and management, as necessary, prior to audit committee meetings to not only better understand matters to be discussed with the audit committee but to assist the chair in prioritizing the topics to be discussed and the time allotted to them.

WHO ELSE IS NEEDED TO SERVE ON THE AUDIT COMMITTEE?

To obtain a balanced perspective, in addition to the financial expert, we recommend two to five additional members with diverse backgrounds and experience. Their knowledge should be consistent with the applicable stock exchanges’ definition of “financially literate.” This generally means that the committee member must be able to read and understand fundamental financial statements sufficiently to recognize when the numbers along with associated disclosures do not make business sense. This ability, coupled with diligence and an inquisitive attitude, will enable members to ask insightful questions and thoughtfully assess the responses.

There are various places to look for qualified audit committee members. Referral sources to consider include executive search firms and professional organizations, such as the AICPA’s Audit Committee Matching System accessible via <http://www.aicpa.org/Volunteer/AuditCommitteeMatchingCenter/Pages/index.aspx> and the National Association of Corporate Directors (NACD) Directors Registry.¹³

►BDO INSIGHT

In addition to financial expertise, serious consideration should be given to one’s expertise within a certain industry. For example, software companies must navigate specialized rules relative to revenue recognition and financial institutions must address complex accounting standards when accounting for financial instruments. When evaluating if members have the required expertise, we believe that audit committees should assess if its candidates have the capacity or background to fully grasp the issues relative to a specific industry.



▶ THE WHATS

WHAT SHOULD BE THE MISSION OF AN EFFECTIVE AUDIT COMMITTEE?

Quite simply, the audit committee's mission is **oversight**. More specifically, this oversight should be focused on the following areas:

- **Financial reporting** – Conduct and integrity of financial reporting;
- **Risk management** – Inclusive of internal accounting and disclosure controls; and
- **Audit function** – Oversight of and communication with independent auditors, both internal and external

WHAT ARE THE BASIC RESPONSIBILITIES¹⁴ OF AN AUDIT COMMITTEE?

The SEC requires an issuer's audit committee to meet the following five standards for the issuer's securities to be listed:

- **Independence** – In addition to helping define WHO an audit committee member should be, independence is considered a basic continuing responsibility of an audit committee member and each member of the audit committee must be independent and remain so under specified narrow criteria. See prior discussion on independence.
- **Responsibilities relating to Registered Public Accounting Firms** – The audit committee must be directly responsible for the appointment, compensation, retention, and oversight of the work of

auditors who provide audit services to the issuer (whether the services are provided by the principal auditor or another firm).

- **Procedures for handling complaints** – The audit committee 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.
- **Authority to engage advisors** – The audit committee must have the authority to engage independent counsel and other advisors as it deems necessary to carry out its duties.
- **Funding** – The issuer must provide appropriate funding for the audit committee to compensate the outside auditors and any independent counsel and advisors it employs and to fund ordinary administrative expenses of the audit committee that are necessary in carrying out its duties.

The following discussion is organized around these basic standards and is somewhat expanded to encompass the fuller scope of actual audit committee responsibilities in keeping with the broader concept of oversight.

“[The requirements of the Act] place the audit committee squarely at the center of the relationship between a public company and its auditor. The provisions of the Act that deal with the audit committee’s oversight of the audit are predicated on the idea that independent, informed, and proactive audit committees can and should be key to protecting the interests of public company investors.”

– Excerpted from the September 21, 2010 PCAOB Roundtable “*Communications with Audit Committees*” briefing paper

WHAT SUGGESTED SPECIFIC ACTIVITIES OR DUTIES SHOULD AN AUDIT COMMITTEE UNDERTAKE TO MAXIMIZE ITS EFFECTIVENESS AND CONTRIBUTION TO THE ORGANIZATION IN LIGHT OF ITS RESPONSIBILITIES?

►BDO INSIGHT

One of the audit committee's most challenging assignments is choosing specific duties to perform. The following observations on the extent of the audit committee's role have come from a number of sources, including the Treadway Commission, the SEC, the various exchanges, the PCAOB and the Blue Ribbon Committee along with our own practical experience.

►INDEPENDENCE

An awareness of the independence rules is essential to maintaining audit committee independence. To that end, we recommend 1) that audit committees and the companies they serve work with their legal counsel to develop a process whereby independence rules are communicated on a regular basis, and 2) audit committee members annually confirm their independence in writing. Many companies regularly circulate a questionnaire to audit committee members that asks detailed questions to enable members to assess and confirm their independence. Often, an explanation of the independence rules is attached to these questionnaires.

►RESPONSIBILITIES RELATING TO REGISTERED PUBLIC ACCOUNTING FIRMS

Evaluating the capabilities of auditors

Within the ever changing marketplace, the audit committee is now considered the public accounting firm's “client” with the responsibility to hire and fire, pre-approve services, review compensation and conduct regular communications with the auditors. In deciding on whether to retain and, as applicable, recommend shareholder ratification of the auditors, the audit committee should consider a number of factors that impact the auditors' capabilities in the context of the company's needs. Refer to the chart on the following page which outlines BDO's recommended considerations to be made by audit committees.

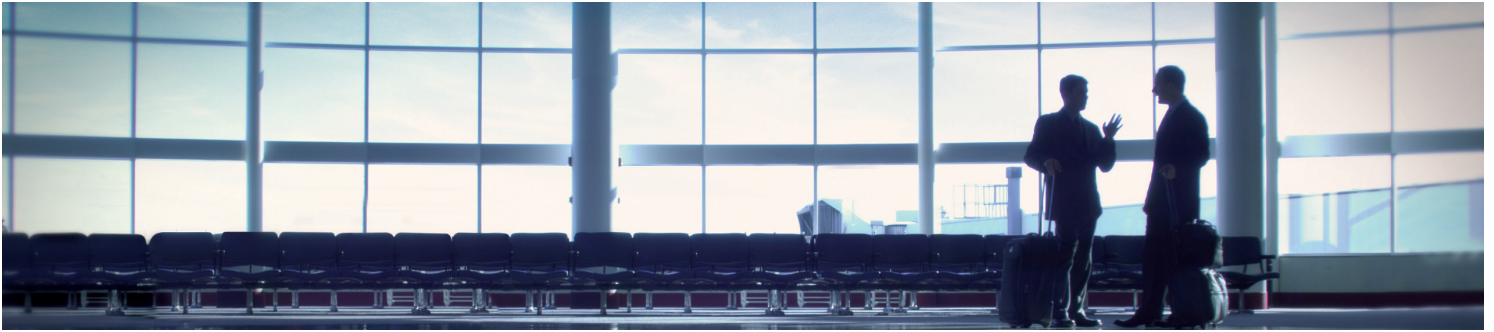
In addition, the AICPA's *Audit Committee Toolkit* contains a practice aid entitled, “*Evaluating the Independent Auditor: Questions to Consider*” for further reference. The Toolkit is available for purchase and accessible from the AICPA's Audit Committee Effectiveness Center at: <http://www.aicpa.org/ForThePublic/AuditCommitteeEffectiveness/Pages/ACEC.aspx>.¹⁵

Pre-approval of services by audit committees¹⁶

Audit committees are required to pre-approve all audit and permitted non-audit services. An auditor will be deemed to lack independence if he or she performs services without the required pre-approval.

The audit committee can either approve a service (1) directly before the accountant is engaged, or (2) indirectly via pre-approval policies and procedures it establishes. Pre-approval policies and procedures must be “detailed as to the particular service,” the audit committee must be “informed of each service,” and the policies and procedures must “not include delegation of the audit committee's responsibilities ... to management.”

The Act allows for one or more designated audit committee members who are independent to pre-approve services and requires the decisions of those members to be reported to the full audit committee at each of its scheduled meetings.



The SEC noted that although the Act permits an audit committee to pre-approve a service at any time in advance of the activity, it expects that audit committees will establish policies limiting the period in advance of the activity for which the approval may be granted.

The rules do provide a de minimis exception to the pre-approval requirement for permitted non-audit services. The pre-approval requirement is waived if the services were not recognized at the time of the engagement to be non-audit services and, once recognized, are promptly brought to the attention of the audit committee and approved prior to the completion of the audit. The aggregate amount of all services approved in this manner may not constitute more than five percent of the total fees paid to the auditor during the fiscal year in which the services are provided.

► BDO INSIGHT

The 5% de minimis exception discussed previously applies only to permitted non-audit services. It does not provide for approving an audit service after-the-fact, and there is no de minimis exception for prohibited non-audit services (which are discussed below). In addition, the exception is available only if the after-the-fact approval occurs before the completion of the year-end audit. An audit is considered completed on the date a company files the auditor's report with the SEC.

Thus, companies and auditors should take extra steps to (1) make sure all audit services are pre-approved, (2) prevent the auditor from inadvertently providing prohibited non-audit services, and (3) identify all non-audit services provided before the company files its financial statements with the SEC.

In that regard, audit committees should note that the rules view the concept of audit services broadly (e.g., statutory audits and comfort letters are viewed as audit services under these rules). This increases the risk that a service inadvertently performed without pre-approval could be a service for which after-the-fact approval is not permitted. To reduce this risk, audit committees should consider pre-approving audit services relatively broadly. For example, an audit committee might approve "statutory audits in all countries where they are required," rather than "statutory audits in countries A, B, C, and D." In addition, the exercise of preparing the disclosure of the fees paid to the auditor should be completed before a company files its annual report – not deferred until the time the proxy statement is prepared. This exercise would increase the likelihood that de minimis non-audit services inadvertently performed without pre-approval can be approved before the company files its financial statements.

AS PART OF ITS **INITIAL** AND **CONTINUING EVALUATION** OF THE CAPABILITIES OF ITS AUDITORS, WE SUGGEST THAT AUDIT COMMITTEES CONSIDER THE FOLLOWING:

SPECIFIC CONSIDERATION	QUESTIONS TO ASK
Technical, industry and public company reporting expertise and depth, including geographic reach	<p>Does the firm have experienced staff and depth of resources to handle the complexity of accounting and reporting matters required in today's environment and as relates specifically to the company's industry, operations and business?</p> <p>Does the firm participate in industry-related forums (specifically with regard to financial, accounting and reporting matters) that have input into the evolving accounting and reporting practices and guidance?</p> <p>Does the firm have the geographic reach necessary to service the company fully and efficiently?</p>
Independence	<p>What are the firm's policies and procedures for ensuring independence of their partners and personnel with respect to the company?</p> <p>Does the firm, in conjunction with the company's operating environment, have adequate mechanisms in place to ensure that independence violations (e.g., with respect to employment of former audit engagement team members, pre-approval of services, etc.) do not occur?</p>
Quality control policies and procedures	<p>Does the firm have adequate quality control policies and procedures in place to ensure services rendered meet professional and regulatory requirements as well as client expectations?</p> <p>What incremental policies and procedures, above those required by professional and regulatory requirements, does the firm employ to provide added quality in the process of rendering professional services?</p>
Engagement team composition	<p>What is the ratio of staff to partners, and staff to partners plus senior managers?</p> <p>How does the audit firm manage continuity on engagements?</p> <p>What are some of the metrics that the firm uses to monitor performance of its senior engagement team members?</p>
Training and technical support	<p>What are the firm's professional credentials (breadth, depth and presence of National office providing support internally)?</p> <p>How does the firm prepare its personnel with respect to meeting professional standards and servicing clients?</p> <p>How does the firm ensure its professional personnel remain up-to-date on evolving technical rules?</p>
Frequent and meaningful communications and interactions with audit committees and management	<p>What methods and tools does the firm employ to ensure frequent, meaningful communications and interactions with the audit committee and management?</p> <p>More specifically, how does the firm ensure that all required communications occur between the auditors and the audit committee?</p> <p>What programs does the firm have in place to help audit committees and management keep up-to-date with respect to evolving issues of significance and relevance?</p>

WHAT IS CONSIDERED AN AUDIT VS. NON-AUDIT SERVICE?

The SEC acknowledges four categories of services rendered by the auditor. Fees grouped by these categories must be disclosed in the annual reports and annual proxy statements of issuers.

These categories consist of the following:

Audit services – the aggregate fees billed for professional services rendered by the principal accountant for the audit of the registrant's annual financial statements and review of financial statements included in the registrant's quarterly filing or services that are normally provided by the accountant in connection with statutory and regulatory filings or engagements.

Audit-Related Fees – the aggregate fees billed for assurance and related services by the principal accountant that are reasonably related to the performance of the audit or review of the registrant's financial statements and are not reported under "audit services."

Tax Fees – the aggregate fees billed for professional services rendered by the principal accountant for tax compliance, tax advice, and tax planning.

All Other Fees – the aggregate fees billed for products and services provided by the principal accountant, other than the services included in the other three categories listed above.

WHAT SERVICES ARE AUDITORS NOT ALLOWED TO PROVIDE TO ISSUERS?

The SEC's list of prohibited services is based on three basic principles:

- An auditor cannot audit his or her own work;
- An auditor cannot perform management functions; and
- An auditor cannot act as an advocate for his or her client.

►BDO INSIGHT

As noted in the pre-approval requirements discussion previously, the rules do not provide a *de minimis* exception for prohibited services. Companies and auditors should evaluate and consider strengthening their controls to prevent the auditor from inadvertently providing prohibited non-audit services.

For the first five prohibited services listed to the right, the rules state that they are prohibited unless it is "reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the client's financial statements."¹⁷ We understand that the SEC staff's position is that a successor auditor's independence would not be impaired if the successor auditor provided prohibited non-audit services in the current audit period and these services (1) relate solely to the prior period which is audited by the predecessor auditor, (2) will not be subject to audit procedures by the successor auditor, and (3) are not management functions.¹⁸

Prohibited services include:

- Bookkeeping
- Financial information systems design and implementation
- Appraisal or valuation
- Actuarial
- Internal audit outsourcing
- Management functions
- Human resources
- Broker or dealer, investment advisor, or investment banking
- Legal
- Expert services unrelated to the audit
- Certain tax services

These rules became effective in May 2003. For a more in-depth discussion of these services and more recent rulemaking pertaining to permitted/prohibited services and BDO's observations, please refer to BDO's summary document *Independence Considerations: Permitted/Prohibited Services* available within our Ac'senseSM website at: <http://www.bdo.com/acsense/>.

With these rules in mind, audit committees are well-served by establishing formal yet flexible pre-approval policies with regard to audit and non-audit services that are reflective of the nature of the company's operations and business needs. The *Report of the NACD Blue Ribbon Commission on The Audit Committee* contains a sample of audit committee pre-approval policies that may be helpful.¹⁹

►REQUIRED COMMUNICATIONS

WHAT ARE THE REQUIRED AND OTHER DESIRABLE COMMUNICATIONS THAT AUDIT COMMITTEES SHOULD HAVE WITH THE AUDITORS?

An auditor is required to communicate the following matters to the audit committee before the company files the auditor's report with the SEC:

- Critical accounting policies and practices used by the company;
- Alternative accounting treatments within GAAP related to material items that have been discussed with management; and
- Other material written communications between the accounting firm and management (e.g., management representation letters, engagement letters, etc.).

PCOAB Rule 3526²⁰ requires auditors of public companies to communicate the following:

- Both *prior* to accepting an initial public company engagement and *at least annually* –
 - (1) describe, in writing, to the audit committee, all relationships between the registered public accounting firm or any affiliates of the firm and the potential audit client or persons in financial reporting oversight roles at the potential audit client that, as of the date of the communication, may reasonably be thought to bear on independence;
 - (2) discuss with the audit committee the potential effects of the relationships described in subsection (1) on independence; and
 - (3) document the substance of its discussion with the audit committee.

PCAOB Rule 3526 requires that *prior to* accepting an initial engagement pursuant to the standards of the PCAOB and *at least annually* after that, the auditor should also affirm to the audit committee, in writing, that, it is independent in compliance with PCAOB Rule 3520, *Auditor Independence*.

In addition, the PCAOB codification of interim standards within its AU Section 380 incorporates the guidance contained in AICPA Statement on Auditing Standards No. 61 (SAS 61), *Communications with Audit Committees*, and SAS 90, *Audit Committee Communications*, which, combined with PCAOB Auditing Standard No. 5 (AS 5), *An Audit of Internal Control Over Financial Reporting That is Integrated with an Audit of Financial Statements and Related Independence Rule and Conforming Amendments*, require auditors to communicate the following items to audit committees of public companies^{21,22}:

- The auditor's responsibility under generally accepted auditing standards ("GAAS") or PCAOB standards – This essentially covers the nature and limitations of an audit.

- Overview of the planned scope and timing of the audit
- Significant findings from the audit – which include:
 - a. Accounting policies*
 - b. Management judgments and estimates*
 - c. Corrected and uncorrected misstatements
 - d. Other information in documents containing audited financial statements – This refers to the auditor's limited responsibility for other information containing audited financial statements (e.g., MD&A, selected financial data, etc.).
 - e. Disagreements with management – These include accounting or auditing matters, whether or not resolved to the auditors' satisfaction. This is a particularly important area because it can shed light on the aggressiveness of executives in attempting to manage earnings or the true financial picture of the company.
 - f. Consultation with other accountants – This involves evaluation of the appropriateness of management seeking a second opinion on significant accounting or auditing issues.
 - g. Major issues discussed with management prior to retention – This requirement is aimed at detecting whether management might be prone to "opinion shopping."
 - h. Significant difficulties encountered in performing the audit – This area may encompass such issues as delays in providing information to the auditors and lack of cooperation.
 - i. The quality, not just the acceptability, of the entity's accounting principles as applied in its financial reporting.*
- Representations requested from management
- Illegal acts
- Fraud*
- Internal control matters – specifically, significant deficiencies and material weaknesses*

* Refer to further, more in-depth discussions below.

►BDO INSIGHT

In regard to the planned scope and timing of the audit, we feel that communications should occur on a timely basis and include discussion of the auditors' approach to risk, materiality and internal control as well as the extent of interaction between the external and internal auditor to better equip those charged with governance to more fully understand the scope of the work to be performed and determine whether adjustments to this scope may be required, as necessary.

While auditors are required to communicate the above items to audit committees in connection with annual audits, they should also provide updates on a timely basis for any significant changes noted in connection with interim ("quarterly") reviews or the filing of registration statements.

As required by AICPA SAS 90 (and codified within PCAOB AU Section 380), auditors are further required “to participate in open and frank discussions with the audit committee about the auditor’s judgments of the **quality**, not just the acceptability, of the company’s accounting principles as applied in its financial reporting throughout the audit.” This includes “such matters as the consistency of the entity’s accounting policies and their application, and the clarity and completeness of the entity’s financial statements, which include related disclosures... also includes items that have a significant impact on the representational faithfulness, verifiability, and neutrality of the accounting information included in the financial statements.”

►BDO INSIGHT

Accounting rules are not always precise. Quite often there is great latitude in the judgments that produce financial statements. These quality discussions present a great opportunity for the audit committee to ask direct questions about how different issues are handled by the company and should be an integral part of the communications process with the auditor.

Refer to the [Appendix](#) for a tabular listing of Auditor Required Communications with Audit Committees and reference to applicable technical guidance.

Status²³: At the time of this publication, the PCAOB had re-opened the comment period through October 2010 on its *proposed* standard, *Communications with Audit Committees*, which would supersede the PCAOB interim standards AU 380, *Communications With Audit Committees*, and AU 310, *Appointment of the Independent Auditor*. The primary objective of the proposed standard is to assist in providing more meaningful and robust dialogue between the auditors and the audit committees. The PCAOB’s public roundtable held in September 2010 was intended to help address the following within the final standard: (1) identify which auditor communications constituents feel are beneficial to audit committees; (2) determine how required communications can be structured to enable the auditor and the audit committee to focus on the most significant accounting issues and estimates; (3) determine how requirements of the proposed standard can improve upon the effective two-way communication between the auditor and audit committee; (4) determine how matters should be communicated – orally or in writing; (5) whether audit engagement letters should include the responsibilities of the audit committee in addition to those of the auditor and management; (6) determine how to avoid auditor duplication of communications made by management; and (7) whether the level of detail of uncorrected misstatements provided to the audit committee should be the same as that provided to management.

WHAT SHOULD AUDIT COMMITTEES BE FOCUSED ON IN CONSIDERATION OF RELIABLE AND TRANSPARENT FINANCIAL REPORTING?

The audit committee must have an **UNWAVERING MANDATE** for financial statements that **TRANSPARENTLY** and **MEANINGFULLY** portray the company’s circumstances.

Identifying and managing risk across an organization is one of the chief aspects of sound corporate governance. Risk management is the process by which management, subject to **oversight** by the board and audit committee, assesses the nature and scope of risks applicable to the company, designs and applies appropriate controls to minimize risks and monitors the controls to ensure that they are working effectively.

In order to achieve its goal of risk management and combating financial fraud, the audit committee must have an unwavering mandate for financial statements that transparently and meaningfully portray the company’s circumstances. Some steps in achieving this include:

- Ensure adequate review of the annual stockholders’ report and Form 10-K before release to the public. The audit committee should clearly understand the following:^{*}
 - Significant accounting judgments made and estimates included in the financial statements
 - Accounting treatment of significant or unusual transactions
 - Impact of changes in accounting rules
 - Required disclosures

^{*} Note: This may be best achieved through open and frank quality discussions with management as well as the auditors, as indicated previously.

Critical accounting estimates are under much closer scrutiny. Given the current economic environment, all parties are paying close attention to estimations of fair value and impairment; reserves for excess inventory/obsolescence; allowances for doubtful accounts; liabilities for employee benefit plans; liquidity; as well as other sensitive areas. Audit committees need to focus their attention on how management is applying judgment within accounting standards and specifically, on the assumptions used that underlie these critical accounting estimates. Recent practice by the SEC has been to issue “Dear CFO” illustrative letters asking certain public companies for information on the accounting for such things as complex financial transactions, fair value assessments, loan loss reserves, etc. to provide insight into how assumptions are being made. The intent of these letters was to assist public companies to better comply with disclosure requirements within MD&A and has resulted in broad adoption by companies and their auditors as “best practices.”

- Evaluate the appropriateness of management seeking a second opinion on significant accounting or auditing issues.
- Look for “red flags” which may signal improper earnings management or, worse, fraudulent financial reporting, misappropriation of funds or illegal acts. In that regard, question management and the auditors about such matters as unusual fluctuations in revenue and expenses, inexplicable reserves, changes in accounting principles or business terms, significant new sources of revenue, and widening disparities between cash and accrual earnings.
- Review audit adjustments made and those waived because of immateriality. The SEC is concerned when companies use overly narrow concepts of materiality to avoid making adjustments to the financial statements. They are particularly concerned when adjustments are made (or not made) to help a company meet or exceed analysts’ consensus earnings estimates. The SEC has made it clear that using purely quantitative materiality criteria (e.g., “5% to 10% of net income”) is not enough. Quantitative criteria may be a good first step; however, registrants should also consider qualitative factors, such as adjustments made or not made to satisfy analysts’ estimates, turning a loss into a profit, the effect on earnings trends, and the effect on the results of individually reported segments of the business.
- Review the quarterly SEC filings. The audit committee should communicate with the external auditors prior to the filings to determine if any matters were identified about which the committee should be aware (e.g., a sensitive accounting estimate or a change in a significant accounting policy affecting the interim financial information).
- Ensure that the financial reports clearly reflect true company performance. In doing so, the committee should be familiar with critical performance indicators such as industry trends and ratios.

SPOTLIGHT: XBRL

eXtensible Business Reporting Language or XBRL, allows for the electronic communication of business and financial data (a.k.a., interactive data) on an international basis. XBRL allows for individual disclosure items within business reports to be assigned unique electronically readable tags (similar to a barcode). These tags are mapped to taxonomies, or standard definitions, developed by market constituents and are publicly available at <http://xbrl.us/TAXONOMIES/Pages/default.aspx>. This tagging then allows for data to be more easily extracted, searched and analyzed for comparisons/benchmarks with competitors, across industry lines and within markets or indices.

In 2009, the SEC issued [Release 33-9002](#) adopting final rules requiring filers to provide financial statements in XBRL format as exhibits – this includes a company’s balance sheet; income statement; statements of comprehensive income, cash flows and owners’ equity; footnote disclosures and financial statement schedules.* The rules are being phased in as of the first quarterly report on Form 10-Q or annual reporting on Form 20-F or Form 40-F that contains financial statements for fiscal periods ending on or after June 15, 2009 as follows:

YEAR 1: Large, accelerated domestic and foreign filers that use U.S. GAAP and have a worldwide public float above \$5 billion (determined as of the end of their 2nd fiscal quarter of the most recent fiscal year).

YEAR 2: All other large accelerated filers using U.S. GAAP with a public float above \$700 million (determined as of the end of their 2nd fiscal quarter of the most recent fiscal year).

YEAR 3: All other filers, including smaller reporting companies and all foreign private issuers that use IFRS.

*Note: The SEC’s final rule does not require auditor assurance on XBRL exhibits. Nor does it require that filers provide interactive data for MD&A, executive compensation or other financial, statistical or narrative disclosure.

Audit committees should be focused on the following in discussions with regard to XBRL:

- Is the company adequately prepared for XBRL reporting?
- What are the costs, benefits and potential risks in complying with XBRL reporting?
- How can the audit committee use available XBRL information provided by the company and its peers to enhance its business acumen and better its understanding of risks faced by the company?

For further information/education on XBRL, visit <http://xbrl.sec.gov/>.

"Audit committees need to develop strong company ethics programs that communicate expected behavior, candor with management and immediate attention to issues."

– Jack Weisbaum, CEO, BDO USA, LLP.



WHAT SPECIFIC STEPS MIGHT THE AUDIT COMMITTEE UNDERTAKE IN ASSESSING THE TONE AT THE TOP AND ENSURING THE ETHICAL BEHAVIOR WITHIN AN ORGANIZATION?

We will continue to stress the importance of understanding an organization's **tone at the top** because it provides the basis for ethical behavior within an organization. Under Section 406 of the Act, a company is required to disclose whether or not it has adopted a **code of ethics** for senior financial officers. A "code of ethics" encompasses such standards as are reasonably necessary to promote:

1. Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
2. Full, fair, accurate, timely and understandable disclosure in the periodic reports required to be filed by the issuer; and
3. Compliance with applicable governmental rules and regulations.²⁴

Most audit committees believe that they can assess the tone at the top from their periodic meetings with management. However, best practices continue to develop which, in addition to these periodic meetings, may include more formal assessments, such as conducting confidential employee surveys, focus groups, one-on-one discussions with second and third levels of management, as well as holding separate discussions with internal and external auditors.

For further insight, refer to BDO's *Ac'sense Ethics and the Corporate Board* archived webinar that explores the challenges of promoting ethics and practicing corporate oversight and governance in the current economic climate available at: <http://www.bdo.com./acsense/events/EthicsCorporateBoard-Oct09.aspx>.

WHAT CAN AUDIT COMMITTEES DO TO BETTER UNDERSTAND THE COMPANY'S RISKS, INCLUDING FRAUD RISKS, AND THE ADEQUACY OF CONTROLS IN PLACE TO MITIGATE THOSE RISKS?

The global financial crisis and economic turbulence continues to expose companies that have poor risk assessment and management practices and should serve as a warning to all companies. The seeds of financial fraud are sown in the combination of business and financial risks facing a company and the inability of existing internal controls to cope with them. The most prevalent means for committing fraud include an override of internal controls by management, especially senior management.

In order for the audit committee to monitor risks effectively, it must first understand them. Within its *Effective Enterprise Risk Oversight* guidance (see link below), COSO indicates that monitoring of risk cannot be done effectively in an ad hoc fashion but rather, requires an approach that looks broadly at the organization (through an enterprise framework) that encompasses: a comparison of the company's strategies with its *appetite for risk* (that is, the level of risk a company may be willing to accept in order to increase shareholder value); an understanding of the processes employed by management to identify, assess and manage risk; and a means for reviewing and appraising management's response to significant risks. Then, by recognizing that **a strong internal control system is the key to risk management**, it can create the right **tone at the top** to foster the growth of suitable controls. Some considerations:

- Review risk assessments developed by management and the auditors. Risk comes in many forms, including economic, legal, financial, environmental, market, technological and competitive. The audit committee cannot be expected to be responsible for continuous monitoring of all business and financial risks, but rather should rely on the special skills and research of other parties to provide input. The audit committee should ask management and the internal and external auditors about their assessments of business and financial risks in areas relating to the audit committee's responsibility. This evaluation should cover each key business segment and the general

functions that have financial reporting implications. The audit committee should perform these inquiries on a regular basis and receive updates whenever there is a significant change in risk.

- Receive internal auditors' reports directly with no management filtering. Direct interaction with the internal auditors can give the committee a sense of the effectiveness of the company's internal control and its compliance with laws, regulations and company policies.
- Review internal and external auditors' recommendations for improving controls as well as management's responses to those recommendations. In doing so, the audit committee should focus on more significant control weaknesses. Understanding management's actions and attitudes toward improving control procedures enables the audit committee to better understand management's tone at the top.
- Ensure that the company's infrastructure can support its current and future financial reporting needs. The management information systems must be able to provide management with all the information it needs to run the business while producing clear, accurate and timely external financial reports. For companies that grow through acquisition, management also needs to be mindful of the need for the acquired companies' systems to be compatible with those of the company.
- Obtain written representations from management on the effectiveness of the company's internal controls and information systems.
- Work with the full board and other committees of the board, as necessary, to ensure that a broad assessment of risk is understood and considered.

Some resources to consider include:

COSO's *Effective Enterprise Risk Oversight – The Role of the Board of Directors*

http://www.coso.org/documents/COSOBoardsERM4pager-FINALRELEASEVERSION82409_001.pdf

COSO's *Enterprise Risk Management – Integrated Framework (Executive Summary)*

http://www.coso.org/documents/COSO_ERM_ExecutiveSummary.pdf

COSO's *Strengthening Enterprise Risk Management for Strategic Advantage*

http://www.coso.org/documents/COSO_09_board_position_final102309PRINTandWEBFINAL.pdf

Refer to the internal control section below for further information.

►BDO INSIGHT

The audit committee should be alert for areas where management and senior management have the ability to override otherwise effective internal controls. Potential ways to mitigate override are included within the AICPA's "*Management Override of Internal Controls: The Achilles Heel of Fraud Prevention*"²⁵ and include independent review of financial reports, internal and external audit procedures and analytical review procedures. The audit committee should understand and assess how the auditors, both external and internal as well as the company's compliance department, address the risk of management override of internal controls. For companies that have experienced issues in the past with respect to errors, fraud, and/or management override of controls, audit committees are further encouraged to perform look-backs on historical breaches of internal control and inquire as to how the organization is better prepared to address those risks today.

WHAT IS THE EXPECTED RESPONSIBILITY OF THE AUDIT COMMITTEE AS COMPARED TO THE BOARD WITH RESPECT TO RISK OVERSIGHT?

Currently, there is debate over the division of responsibilities between the board of directors and other committees of the board (e.g., audit, compensation, finance and nominating committees), specifically with respect to risk oversight. While most agree that risk management is a shared responsibility, many would agree that audit committees should focus on risks related to financial reporting and not be overloaded with a company's entire risk matrix. In 2009, the SEC issued [Release No. 33-9089 Proxy Disclosure Enhancements](#) to enhance disclosures made regarding compensation policies and practices as they relate to risk management, board leadership structure and its role in risk oversight. The rule requires public companies to describe the board's role in the oversight of risk, citing that this is a key competence of the board. The rule provides "flexibility" in describing how the board administers its risk oversight function, e.g., through the whole board or through a separate risk committee or audit committee. Based upon a review of various proxy statements filed during 2010, companies have taken different approaches in terms of disclosing the handling of risk: some boards delegate responsibility directly to the audit committee; others indicate broadly it is a shared responsibility between the board and its committees; while others detail the specific risk areas that each committee of the board is responsible for.

During a 2010 NACD Audit Committee Issues Conference, the Roundtable panel, which included directors from *Fortune 500 companies*, generally agreed that the full board should oversee the strategic risks facing the company and indicated that it sees the audit committee's responsibility for risk often narrowing to risks within

NAVIGATING ECONOMIC TURBULENCE

Given the slow financial recovery that we continue to experience, investors are keenly interested in how management is planning to navigate the remaining economic turbulence. The following is a list of topics that those charged with governance should be prepared to address in connection with the current economic environment:

Planning for a Recovery. Given many forecasts for a slow, uneven economic recovery, shareholders may want to know if the company has adopted a comprehensive plan based on real-time reporting that will provide management with the ability to react quickly to opportunities or further downturns in the market.

Funding a Recovery. Despite positive economic signs in some business sectors and geographic areas, credit remains tight. Shareholders may want to know how management plans to access capital to fund current operations, build up inventories and fuel expansion should opportunities arise.

Accessing Public Equity Markets. Despite the poor performance of initial offerings thus far in 2010, U.S. IPO activity is well ahead of last year's pace and there is a pipeline of companies considering going public when the market is receptive. Shareholders will want to know if that same market activity will translate to offerings from existing public companies and if management is considering a securities offering.

Quality Controls. Most businesses have undertaken significant streamlining programs to deal with the recession. Shareholders may ask how these programs have affected quality control from both an operational and financial standpoint.

SEC Compensation Risk Assessments. Reports of excessive compensation during times of poor economic performance have riled shareholders in recent years. The SEC has introduced new requirements in 2010 for corporate compensation risk assessments at all levels. Shareholders may want to know what the company has done to identify and address compensation risk in order to fulfill the new SEC requirements and avoid penalties.

Financial Risk Management. Given the losses numerous companies sustained from investments in subprime mortgages, collateralized debt obligations, asset-backed securities, auction rate securities, etc, shareholders may want to know what risk management changes have been made to avoid similar losses in the future.

Changing Accounting Practices:

On-The-Balance Sheet. A number of financial institutions incurred losses rescuing off-balance-sheet entities. New accounting rules will require most of these entities to be consolidated. How will these "on-the-balance-sheet" entities impact financial statements moving forward?

Are Companies Prepared for IFRS? The SEC has reiterated its support for a single set of high quality global accounting standards. While a decision as to how the SEC plans to integrate IFRS into the market for U.S. public entities will not be made until 2011, shareholders may want to know: Is management, along with company-wide systems and processes, prepared to implement a conversion in the future; what the conversion may cost; and how it might affect earnings per share?

Fair Value Accounting. Does the company expect to experience wide fluctuations in the value of assets and liabilities due to fair value accounting?

Public Interest Issues. Will businesses be increasing their political contributions in light of the recent Supreme Court decision removing caps on corporate contributions? Shareholders may also ask for reports that describe the company's environmental and sustainability policies.

Impact of Changes To Income Taxes. Will new federal and state government tax initiatives – such as the Obama administration's plans that could significantly change current tax provisions affecting foreign operations – impact the company's ability to grow and invest in the business?

the audit committee's core areas of oversight – financial reporting, compliance, IT and sometimes, financial risks.²⁶

WHAT IS THE AUDIT COMMITTEE'S ROLE IN THE PREVENTION, DETERRENCE AND DETECTION OF FRAUD?

No discussion of risk would be complete without a direct consideration of the risk of fraud and the responsibilities for dealing with fraud. AICPA Statement on Auditing Standards No. 99, adopted by the PCAOB as part of its interim standards (AU 316), outlines the following roles with


respect to fraud: Auditors have the responsibility to *consider* the risk of fraud in planning and performing their audits, specifically as it relates to misstatements arising from fraudulent financial reporting (e.g., falsification of accounting records) and misstatements arising from misappropriation of assets (e.g., theft or fraudulent expenditures) that may lead to a material misstatement within the financial statements. However, *"it is management's responsibility to design and implement programs and controls to prevent, deter and detect fraud... Management, along with those who have responsibility for oversight of the financial reporting process (such as the audit committee, board of trustees, board of directors, or the owner in owner-managed entities), should set the proper tone, create and maintain a culture of honesty and high ethical*

“The Audit Committee’s oversight responsibility for financial reporting risks transcends most enterprise risks faced by the organization. A financial reporting failure due to fraud often adversely impacts reputation, stock price, employee morale, and the ability to achieve strategic objectives.”

– Glenn Pomerantz, Partner, BDO Consulting

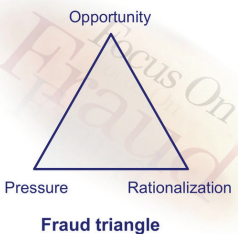
standards and establish controls to prevent, deter, and detect fraud. When management and those responsible for oversight of the financial reporting process fulfill those responsibilities, the opportunities to commit fraud can be reduced significantly.”²⁷ Section 302(a)(5)(b) of the Act requires management, as part of its interim financial reporting certification, to disclose to the auditors and to the audit committee any fraud, whether or not material, that involves management or other employees who have a significant role in internal control.

Audit committees need to understand the following fraud risk factors that are generally present when fraud occurs: **incentive** or **pressure** to commit fraud (e.g., pressure to meet earnings goals); **opportunity** to commit fraud (e.g., absence/lack of controls, ability for management to override controls, etc.); and **rationalization** (e.g., attitude or lack of ethics that allows a person to commit fraud). Together, these factors make up what is widely known as the **fraud triangle**.



Environment That Encourages Fraud

- **Pressure** or an incentive to commit fraud
 - Meet expectations
 - Avoid criticism
 - Cover a mistake
- **Perceived opportunity**
 - Poor internal controls
 - Lack of oversight
- **Rationalization**
 - Low compensation
 - Company is profitable

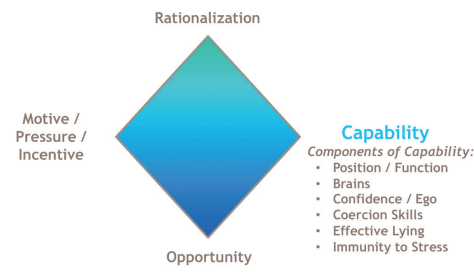


Excerpted from the BDO Ac'sense 2009 self-study course – *Focus on Fraud: Fraud and Misconduct in the Corporate World* accessible at: <http://www.bdo.com/acsense/events/Focus-on-FraudSept09%20.aspx>.

There are several variations, currently in circulation, to the fraud triangle. One such alternative is summarized in a report published by David T. Wolfe, a forensic accountant, and Dana R. Hermanson, a professor of accounting, adding a fourth element – **human capability**, thus, forming the **fraud diamond**,²⁸ to consider an individual’s personal

traits and abilities that play a major role in determining whether fraud will actually occur in the presence of pressure, opportunity, and rationalization. For audit committees, at the core of these fraud models is recognizing *the presence and interaction of the risk factors underlying fraud* as the key to oversight responsibilities for the detection, deterrence and prevention of fraudulent activity.

The Fraud Diamond: Considering the Four Elements of Fraud



Excerpted from the BDO Ac'sense 2010 self-study course – *Focus on Fraud: The Series Continues...* accessible at: <http://www.bdo.com/acsense/events/Focus%20on%20Fraud%20-%20Lessons%20Learned.aspx>.

Building upon various fraud models and based upon its own investigative experience, BDO Consulting (BDOC) – a division of BDO USA, LLP – has identified certain conditions that often create a fertile environment for fraud and negatively impact the audit committee’s ability to oversee management’s anti-fraud initiatives. Such conditions include:

- Lack of awareness of fraud risk factors and warning signs
- Inadequate control activities to mitigate identified fraud risk
- Inadequate screening practices (for employees, vendors, customers and/or business partners)
- Insufficient understanding of ethical duties at all levels
- Ineffective mechanisms for reporting and investigating fraud
- Ineffective board and audit committee oversight

Corporate fraud continues to be a hot topic and a focus in the area of risk management for companies and particularly those charged with

governance. **BDOC's Fraud Prevention Program**³² is based upon the belief that the effectiveness of board and audit committee oversight is a key element in significantly reducing the risk of fraud at an organization and increasing the likelihood that, if fraud does occur, it will be detected at an early stage. To achieve this, audit committees may consider employing the following best practices:³³

- Understand significant fraud risks that the company's business is facing via fraud risk assessment and education
- Understand the programs and controls that management has developed for managing fraud risks, including relevant policies and procedures
- Develop alternative sources of information about what is happening in the company with respect to fraud risks
- Seek supporting documentation and be willing to ask difficult questions

- Have mechanisms *in place* for both reporting (e.g., "whistle-blower hotlines") and conducting independent investigations of fraud
- Independently assess and monitor the effectiveness of those mechanisms

For more information on the Fraud Prevention Program and best practices aimed at the prevention and detection of fraud and conducting internal investigations, you may access live webcasts along with archived replays of our **Ac'sense**SM webinar series: "Focus on Fraud" available at: <http://www.bdo.com/acsense/> or reach out to a member of BDOC's practice at litigationandfraud@bdo.com.

FOCUS ON FRAUD: COSO FRAUDULENT FINANCIAL REPORTING STUDY

In February 2010, COSO issued "*Fraudulent Financial Reporting: 1998-2007*," a report²⁹ which provided a comprehensive analysis of fraudulent financial reporting investigated by the SEC between January 1998 and December 2007. The study reviewed certain key company and management characteristics involved in instances of financial reporting fraud identified in SEC Accounting and Auditing Enforcement Releases (AAERs) and compared these companies to a non-fraud control group. The study further provided insights related to preventing, deterring, and detecting fraudulent financial reporting.

The report contains some interesting overall findings: Compared to the previous study conducted by COSO, which covered the period from 1987-1997, the number of alleged cases of financial reporting fraud increased from 294 to 347, an increase of approximately 18%. The median fraud of \$12 million in the recent study compares to a median fraud of \$4 million in the previous study. Companies allegedly engaging in fraudulent financial reporting (which included start-ups through established companies) had median assets and revenues of just under \$100 million compared to \$15 million reported previously. These facts seem to indicate that the frequency of fraud is increasing; the size of the impact of fraud is increasing; and the size of the companies involved in alleged financial reporting fraud is also increasing. Improper revenue recognition continued to be the leading method of perpetrating financial reporting fraud within 61% of the cases (up from 50% of the cases in the previous study). No particular industry dominated the companies that experienced financial reporting fraud, however, "computer hardware/software" companies and "other manufacturing" companies each represented approximately 20% of the companies

identified in the study. The exchanges on which companies that allegedly engaged in financial reporting fraud were traded also provide interesting information. Approximately 50% of the "fraud" companies in the current study were traded on NASDAQ. However, only approximately 24% of all publicly traded companies are registered on NASDAQ, which indicates a higher proportion of companies experiencing financial reporting fraud are traded on this exchange.

For a statistically significant number of cases of fraud noted in the COSO study, the company had been experiencing financial difficulties. In the majority of the cases, senior management was involved in the fraud and specifically, in 89% of cases, the AAERs named the CEO and/or CFO as being associated with the financial statement fraud. The most commonly cited motivations for fraud included the need/desire to: meet earnings expectations, conceal deteriorating financial condition, increase stock price, bolster financial performance for pending financings, increase compensation based on financial results, and cover up asset misappropriation. Other "red flags" highlighted in the report for fraud companies as compared to the non-fraud control group included higher rate of related party transactions and higher rate of change in external auditors. BDO notes the key take away from this report for **all** audit committees is the need to remain vigilant – be mindful of fraud risk factors, financial stress/pressures and other motivators of fraud, management's tone at the top, etc. – and be willing to challenge management with respect to fraud.

FOCUS ON FRAUD: CAQ PLATFORM FOR ACTION

In October 2010, the CAQ released "*Deterring and Detecting Financial Reporting Fraud – A Platform for Action*,"³⁰ focused on financial reporting fraud at publicly-traded companies of all sizes. This report is based upon a series of discussions and in-depth interviews of corporate executives, board and audit committee members, internal and external auditors, investors, regulators, academics and others. The report centers on three consistent themes identified by participants to mitigate the risk of financial reporting fraud:

- A strong, highly ethical tone at the top that permeates the corporate culture;
- Skepticism, a questioning mindset that strengthens professional objectivity, on the part of all participants in the financial reporting supply chain; and
- Strong communication among supply chain participants.

The report highlights the importance of "an effective fraud risk management program as a key component of the ethical tone at the top." With regard to skepticism, "the CAQ discussion participants stressed that audit committee members should have industry and entity knowledge, including a strong understanding of the economics of the business, in order to identify and understand business and financial risks that may increase the likelihood of fraud." Communication efforts by the audit committee should include routinely asking questions of management and auditors to "elicit indications of potential concerns related to incentives or opportunities for financial reporting fraud" and "seek opportunities to interact with management, employees, vendors and customers to enhance knowledge of the company and possible risks of financial reporting fraud."

The report contains the following suggested questions for audit committees to consider and to further customize when inquiring about financial reporting fraud to uncover potential sources of bias or influence on accounting judgments³¹:

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 concern 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 non-financial 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?

Based upon this initial report, the CAQ intends to foster collaboration with key stakeholders (including the Financial Executives Institute, the NACD, the Institute of Internal Auditors, the PCAOB and others) and focus initial efforts on:

- Advancing the understanding of conditions that contribute to fraud
- Promoting additional efforts to increase skepticism
- Moderating the risks of focusing only on short-term results
- Exploring the role of information technology in facilitating the deterrence and detection of fraudulent financial reporting

Refer to the CAQ's report available at: <http://www.thecaq.org/Anti-FraudInitiative/CAQAnti-FraudReport.pdf>.

WHAT CAN THE AUDIT COMMITTEE DO TO STRENGTHEN THE AUDIT FUNCTION?

As indicated previously, the audit committee's oversight responsibility for the audit function covers work performed by both external and internal auditors.

External Auditors

In addition to the questions posed earlier regarding continually evaluating the capabilities of the external auditors and communications, the audit committee should:

- Interview and evaluate the external auditors from the following perspectives:
 - **Audit approach** – how the firm plans the audit, the timeliness of its services, the efficiency of its performance and how effectively it coordinates the work of other offices, both domestic and international. Also, how it polices its own performance, internal review approach and consulting procedures.
 - **Accessibility and location** – the ability of the firm to respond to issues in a timely manner, including the relative proximity of the auditors to the company's operating facilities and corporate headquarters. This can facilitate cooperation, understanding and face-to-face contact.

SPOTLIGHT: FOREIGN CORRUPT PRACTICES ACT

The Foreign Corrupt Practices Act of 1977, as amended, (FCPA), has been the recent focus of the U.S. Department of Justice (DOJ) and SEC Enforcement and has resulted in significant risk and penalty/violation costs to companies, not to mention the exposure of directors to personal liability. The FCPA generally prohibits the practice of paying or offering to pay (directly or indirectly) money or anything of value to a foreign official to obtain or retain business. Violations under the FCPA can be broad-reaching and may result in significant fines and penalties with respect to anti-bribery provisions as well as to requirements for the maintenance of accurate books and records and the implementation of internal controls designed to prevent corrupt payments. For example, violations can result from:³⁴

- Improper payments made by U.S. companies and citizens that take place either within the U.S. **OR** wholly outside of the U.S.
- "Payments" made in cash or anything of value (e.g., discounts, gifts, use of materials, facilities and equipment, entertainment, benefits, etc.)
- Application of the FCPA's anti-bribery provisions not only to issuers but to "domestic concerns" (i.e., any corporation, partnership, association, joint-stock company, business trust, unincorporated organization, or sole proprietorship with a principal place of business in the U.S. or organized under U.S. law) as well
- Making improper payments to obtain government licenses, registrations, special tax or custom treatment which allow a company to do business in a foreign country (i.e., broad application – not just limited to those activities that directly influence the acquisition or retention of government contracts)
- Inappropriate activities conducted by third parties acting on behalf of the company that the company may be deemed to have (or deemed as should have had) knowledge of
- False characterization of improper payments on a company's books and records – this includes books or records ultimately consolidated for financial reporting purposes

*Note: The DOJ has predicated jurisdiction and thus, FCPA may apply to **non-U.S. companies or concerns**, including foreign corporations and foreign nationals, who commit any act in furtherance of a prohibited payment while in the territory of the U.S.*

A recent article in *Compliance Week*³⁵ reminds us that the SEC and DOJ have been "very vocal about their interest in identifying the highest-level individuals within the organization who are responsible for the tone, culture, or weak internal controls that may contribute to, or at least fail to prevent, bribery and corruption." Knowledge of the potential for FCPA issues is the responsibility of the audit committee. Lack of awareness is not a defense when such issues arise. "Audit committees need to have an understanding of how exposed the company is with respect to bribery and corruption, where that risk lies, what controls are in place to mitigate it, and how management is testing those controls." Best practices highlighted by BDOC's Anti-Corruption Compliance & Investigations Practice³⁶ include the establishment of an FCPA compliance program which includes:

- Understanding and complying with applicable anti-corruption laws and regulations
- Performing due diligence on business relationships (individuals and entities)
- Communicating a consistent "top-down, zero-tolerance" message on creating and maintaining a corruption-free business environment throughout the organization
- Creating a comprehensive training program on anti-corruption policies and procedures to include:
 - regular reporting by management to the audit committee about the Company's compliance program
 - documented assessment of an organization's compliance program to demonstrate that the audit committee is fulfilling its fiduciary responsibility
 - monitoring and regular updates to the program, as necessary
- Responding to allegations of corrupt activities and investigating them in a timely and comprehensive manner

– **The management letter**³⁷ – the content of the firm's letter of recommendations to management, including insights into the company's business and internal accounting control needs, and the completeness of its approach.

– **Working with the audit committee** – the degree of initiative, cooperation and effectiveness of the firm's work with the audit committee.

– **Major litigation** – the likely effect on its business of any significant pending lawsuits against the audit firm.

• Obtain agreement from the auditors that the board (and therefore, the audit committee), rather than management, is the auditors' primary client. To that end, the audit committee needs to make sure the auditors understand their need for a diligent, unbiased audit and an honest appraisal of management. This agreement can help provide free-flowing, candid discussions between the audit committee and the auditors.

• Review the audit fee to ensure that it is in line with the scope of the audit. Based on the review of the auditors' scope and auditing

techniques, subsequent discussions with management about problems encountered and the auditors' efficiency in handling the audit, the audit committee should be in a good position to evaluate whether the engagement time and resulting fees are reasonable. While it may be natural to review the fee solely from the perspective of being "too high," a fee that is too low may actually provide more risk to the company. An "overly aggressive" negotiated fee can put significant pressure on the auditors when determining an appropriate audit scope that adequately addresses the higher risk areas.

Internal auditors

Much of the following can be likened to the responsibilities of the audit committee for external auditors, in that the audit committee should:

- Be apprised of the scope of the internal auditor's work and its specific responsibilities. This would include review and approval of the internal audit department charter, which should describe the mission, accountabilities, independence, responsibilities, authority and standards for the department.
- Be involved in the hiring/termination, selection and compensation of the internal audit department.
- Evaluate the adequacy of the internal audit department personnel, the department budget, as well as when appropriate changes in audit coverage should be made.
- Review any plans to outsource the internal audit function. Challenge the pros and cons of such a proposal.

In addition, the audit committee should review the degree of coordination between the activities of the external and internal auditors. The audit committee should feel confident that the combined audit scope can be relied on to identify weaknesses in internal controls that could expose the company to fraud or material financial reporting errors. Moreover, the committee should encourage open and direct communications with the auditors. Internal auditors, as well as external auditors, must feel free to report control weaknesses (particularly those resisted by management) to the audit committee on a confidential basis without fear of reprisal.

The AICPA's *Audit Committee Toolkit* contains two tools that may facilitate the audit committee's evaluations: "*Evaluating the Independent Auditor – Questions to Consider*" (see prior discussion) and "*Evaluating the Internal Audit Team – Guidelines and Questions*."³⁸

►BDO INSIGHT

Communication is a two-way street that should be designed to ensure that all of the parties involved understand each other's responsibilities and that each receive relevant and timely information to allow those responsibilities to be fulfilled.

►INTERNAL CONTROL OVER FINANCIAL REPORTING

WHAT ROLE DOES THE AUDIT COMMITTEE PLAY IN THE COMPANY'S INTERNAL CONTROL ENVIRONMENT?

"The audit committee plays a critical role in fostering a strong tone at the top, which is the foundation for a robust control environment."

– Wayne Kolins, Partner, Global Head of Audit and Accounting, BDO International Limited

Compliance deadlines with respect to Section 404 of the Act on internal control over financial reporting have been in place for a while now for accelerated issuers and accelerated foreign private issuers. However, the debate has continued for non-accelerated issuers culminating most recently with the *2010 Dodd-Frank Wall Street Reform and Consumer Protection Act*. The Dodd-Frank Act provides for a permanent exemption on compliance with the external auditor attestation provision under Section 404(b) of the Act for non-accelerated filers. These companies will still continue to be required to provide management's assessment of the effectiveness of internal control over financial reporting under Section 404(a). Included within the Dodd-Frank Act is a further charge for the SEC to report within nine months of enactment ways to reduce Section 404(b) compliance costs for companies that have market capitalization between \$75 million and \$250 million.

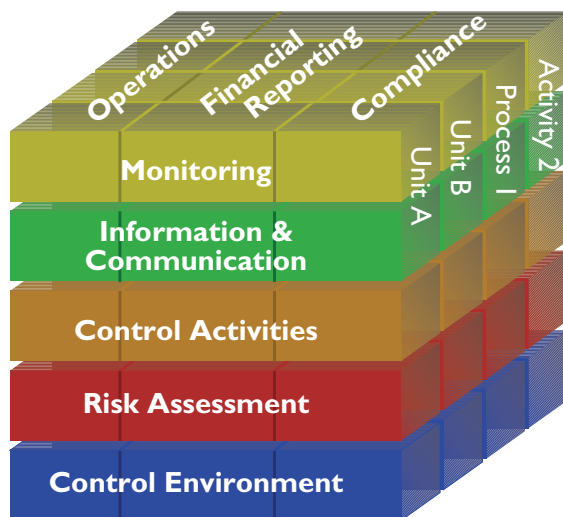
Though buried in a footnote, the 2007 SEC interpretative release on management's report on internal control over financial reporting (ICFR) states, "Because management is responsible for maintaining effective [ICFR], this interpretive guidance does not specifically address the role of the board of directors or audit committee in a company's evaluation and assessment of [ICFR]. However, we [the SEC] would ordinarily expect a board of directors or audit committee, as part of its oversight responsibilities for the company's financial reporting, to be reasonably knowledgeable and informed about the evaluation process and management's assessment, as necessary in the circumstances." [FN 22]³⁹

The PCAOB also acknowledges that while the audit committee plays an important role, management is responsible for maintaining effective internal control over financial reporting. However, as the audit committee is a crucial component of the control environment, the auditors, in connection with their responsibility to audit internal controls under Section 404 of the Act and PCAOB AS 5, will perform a separate and distinct evaluation of the audit committee's effectiveness apart from the assessment performed by the board of directors. If audit committee oversight is deemed to be ineffective, PCAOB AS 5 requires this shortcoming to be reported by the auditors to the board of directors in writing, and further assumes that this would be a material weakness in internal control.⁴⁰

“The benefits of an engaged and active audit committee as a component of the control environment cannot be over emphasized. An audit committee needs to be aware of the areas where bias in the financial statements could occur, and the motivations or pressures that could lead to such bias. They should “walk the talk” of the company’s core ethical values, ask probing questions of both management and the auditors and apply a challenging attitude to the financial information presented for review. This attitude will permeate the organization and its advisors and send a strong message to potential fraudsters.”

– Sue Lister, Partner, National Director of Auditing, BDO USA, LLP

In order to be knowledgeable about management’s evaluation and assessment of internal control, the audit committee needs a good understanding of the company’s framework and related components of internal control. A highly regarded framework used in practice is the COSO *Internal Control – Integrated Framework*⁴¹, which includes the following key integrated components:



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- **Control environment** – tone of the organization
- **Risk assessment** – identification and analysis of relevant risks
- **Control activities** – policies and procedures
- **Information and communication** – relevance and timeliness
- **Monitoring** – ongoing assessment of controls

Understanding of the company’s control environment; how robust the risk assessment process employed by management is; what activities in the form of policies and procedures have been put in place by the company to meet risk management objectives; whether information and communications are relevant and timely to ensure adequacy of the internal control system; and how well the company is able to monitor existing controls to ensure they are operating effectively and efficiently is paramount for the audit committee to then be able to understand how and where things may go wrong.

In this regard, auditors are required to report all significant deficiencies and material weaknesses, in writing, to the audit committee. The PCAOB defines a **significant deficiency (SD)** as a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the company’s financial reporting.

The PCAOB defines a **material weakness (MW)** as a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the company’s annual or interim financial statements will not be prevented or detected on a timely basis.⁴²

WHAT IS THE AUDIT COMMITTEE THEN EXPECTED TO DO WITH SUCH INFORMATION ON REPORTED SDS AND MWS?

If SDs or MWs are identified, the audit committee should ask the following:

- Are these issues pervasive throughout the company or limited to specific location(s) or account(s)?
- Were any of these issues noted in previous years and if so, what does this mean for establishment of an appropriate tone at the top and oversight of ICFR?
- What is management doing to remediate the issues? Is the scope and timing of this remediation adequate?

- What additional controls, policies and/or procedures need to be implemented to ensure a more robust control environment?
- Given the issues noted, are there other areas that need re-evaluation?

For more information on internal control over financial reporting considerations, you may access archived replays of our **Ac'sense**SM webinars available at: <http://www.bdo.com/acsense/>.

For further guidance on monitoring and considerations for smaller public companies with respect to internal controls, refer to the COSO website at: <http://www.coso.org/>. Specific publications include:

- COSO's *Guidance on Monitoring Internal Control Systems*
- COSO's *Internal Control over Financial Reporting – Guidance for Smaller Public Companies* – provides guidance on how to apply the COSO ICFR Framework more effectively and efficiently by all companies, but particularly for smaller public companies where the costs of designing and implementing ICFR can often be prohibitive.

WHAT IS THE AUDIT COMMITTEE'S ROLE WITH RESPECT TO IMPLEMENTATION OF IFRS?

While over 120 countries now require or permit IFRS, the U.S. remains the one major economy that has not yet committed to adoption of IFRS. Most U.S.-based companies are taking a wait and see approach to IFRS implementation. However, given the indicators laid out earlier in this publication that convergence to global standards is indeed continuing, and at a rapid pace, companies should be proactive in assessing the costs and current capabilities of meeting implementation requirements. Within the adoption and implementation of IFRS, the role of the audit committee will remain one of risk management and oversight. As such, while management is responsible for the preparation of IFRS financial statements, the audit committee is expected to be knowledgeable in determining: how implementation of IFRS will impact a company's controls over risks; sufficiency of the level of management expertise; adequacy of plans to integrate the company's business practices as well as its systems (e.g., IT, taxation, legal, contracts, etc.); how estimates and judgments are being made by management related to accounting policy choices in the initial adoption of IFRS; and how effects/results of IFRS reporting should be communicated to shareholders and analysts in ensuring integrity of financial reporting.

As indicated previously, there are significant differences between existing U.S. GAAP and IFRS, many of which may be wholly or partially eliminated prior to U.S. companies adopting IFRS and some of which will not. It is thus, not too early for company management along with their governing bodies to begin getting up to speed with not only the IFRS standards, but the way in which the IASB works and its objectives! For further insight into preparing for IFRS, refer to the *BDO Knows: IFRS August 2010 Implications of IFRS for Audit Committees* publication along with **Ac'sense**SM archived webcasts related to IFRS adoption and transition available within the BDO IFRS Resource Center at: <http://www.bdo.com/ifrs/>.

►BDO INSIGHT

BDO recently reported on its in-depth analysis and interviews with CFOs of 22 European Union-based companies who have recently converted to IFRS in BDO's "*Attitudes to IFRS v2.0*."⁴³ Some of the key findings include:

Focus on timing: All respondents said that they should have started their IFRS conversion much sooner.

Take time in identifying the right solution: A number of respondents commented that they would have taken the opportunity to revisit their accounting policies applied under local generally accepted accounting principles (GAAP) had they started IFRS conversion early enough. Starting late meant missing opportunities to choose the most appropriate accounting policies for their business.

Invest in staff and training during and after the move to IFRS: CFOs continue to invest significant resources, both internal and external, in IFRS conversion, educating and training their own staff, preparing transition balance sheets and issuing their first IFRS financial statements during an intense period of change.

Effectively manage behavioral change: Respondents noted that being proactive in foreseeing changes in company behavior through adoption was important, especially in areas such as sales-force incentive programs, mergers and acquisitions (M&A) activity and employee share-based payment plan arrangements.

Use available materials: The majority of companies took advantage of publicly available IFRS financial statements to use as examples as well as benefitting from the later adoption of accounting standards.

Early involvement of auditors and external advisors: Greater practical experience with the standards has helped recent IFRS conversions run more smoothly. However a number of respondents reported problems with the speed at which auditors cleared complex issues and financial statements. Early dialogue was seen as a potential way to improve this.

Effectively communicate with analysts: Some respondents noted the need to keep analysts up-to-speed and avoid surprises. However, there was not a great deal of consistency in analysts' relative interest in IFRS, with some companies reporting that non-GAAP measures appeared to be more critical to analysts than the new IFRS numbers.

Consider embedding IFRS in monthly reporting: Companies have mixed views on whether to use IFRS, local GAAP or adjusted IFRS non-GAAP measures to report and evaluate performance internally. But with many jurisdictions expected to permit adoption of *IFRS for SMEs* for local GAAP reporting purposes, extended use of local GAAP is expected to diminish significantly.

IFRS standard setters need to remain focused: Some respondents are highly critical of the evolution of IFRS adopted in the European Union and are concerned that political interference could derail global adoption and the achievement of a single-set of high quality global accounting standards.

“The tax provision can represent a significant percentage of net income. Proper controls over financial reporting for income taxes are critical to ensuring accuracy and compliance with both GAAP and regulatory requirements. This has never been more critical than it is today when considering the breadth and depth of existing, new and proposed complex accounting and reporting guidance. Audit committees need to have a good understanding of this and the interrelation between accounting and taxation.”

– Scott Guertin, Partner, National Accounting for Income Tax Practice Leader, BDO USA, LLP

WHAT IS THE AUDIT COMMITTEE'S ROLE WITH RESPECT TO CONSIDERATION OF INCOME TAX MATTERS?

In an address to the New York State Bar Association's Taxation Section Annual Meeting in January 2010, Internal Revenue Service (IRS) Commissioner Doug Shulman made the following point with respect to the role of the corporate board within the tax compliance system:

“Tax expenses are like other major expenses. Manage them too loosely and you give up profit. Manage them too aggressively and there are bad consequences. The board must oversee how management manages them [tax expenses]. And that means some level of understanding, a set of policy principles and then a control system of review and reporting that assures the board that their policy is being carried out. Many corporate boards do have a regular dialogue regarding tax risk with their CFOs, tax directors and external tax advisors. My goal is to promote good corporate governance on tax issues and engage the corporate community in a dialogue about the appropriate role of the board of directors in tax risk oversight. This will continue to be a theme of ours [IRS].”

The income tax area is one that stretches across international, federal, state and local, as well as political lines, and requires quite a bit of expertise in understanding the interplay of both the required financial reporting elements along with a company's tax planning and risk management strategies. “Hot” (and complex) issues surrounding transfer pricing (that is, prices a company records for goods and services exchanged between related parties), foreign tax credits, withholding taxes, compensation and benefits, research and development credits, and M&A activity as well as the implications of ASC 740-10 (“FIN 48” measurement issues in accounting for uncertain tax positions) are just some of the many areas where taxes can have a significant impact on financial reporting for companies.

Similar to the SEC's focus on transparency and disclosure of risk and critical accounting estimates, the IRS appears to be quite interested in how companies govern the tax area. In the fall of 2010, the IRS issued two announcements (IRS 2010-75 and 2010-76) regarding the new IRS Schedule UTP detailing uncertain tax positions, a highly sensitive area

of disclosure for many companies. While the final Schedule UTP requires certain taxpayers (i.e., those companies with assets of \$100 million or greater) to begin disclosing their uncertain tax positions annually for 2010 taxable years, the recent announcements contain welcome guidance and clarification in response to strong public commentary received during the proposal phase. The announcements provide for a number of significant changes to the original draft Schedule UTP and disclosure requirements, easing the reporting required and deferring requirements for reporting for companies with assets under \$100 million to 2012 or 2014 depending on the amount of their assets.⁴⁴

Simply listing these various issues gives pause as to how extensive an area accounting for income taxes can be to an organization and the importance for the audit committees to ensure that they have the appropriate comfort level in regard to whom within the company and external to the company is advising them on tax matters. In addition, the audit committee, as an extension of the corporate board, should set the tone for the level of risk that is acceptable in assessing and taking company tax positions and regularly review the impact of those positions.

For further guidance in this area and on other topics of interest with regard to taxation, refer to the BDO Tax Service Line pages at: <http://www.bdo.com/services/tax/>.

“As a best practice and in contemplation of scrutiny of perceived independence from outside authorities, audit committees should identify and engage independent counsel and/or advisors separate from company counsel/ advisors to provide guidance on fiduciary responsibilities and exposure.”

– Lee Dewey, Partner, BDO Consulting

► PROCEDURES FOR HANDLING COMPLAINTS

WHAT ARE THE BEST PRACTICES FOR ESTABLISHING PROCEDURES FOR HANDLING COMPLAINTS?

The audit committee 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.

We recommend that audit committees adopt a formal “**whistleblower policy**” that includes the following:

- Responsibilities of the audit committee
- Procedures for receiving and investigating accounting complaints
- Policy for protecting whistleblowers
- Confidentiality policies for whistleblowers
- Policy for publication of whistle-blowing procedures

Companies may consider an anonymous telephone hotline as a means for employees to report complaints.

Update: At the time of publication, there have been several developments which could greatly impact a company’s internal ethical culture and its whistleblowing and compliance policies. To summarize: (1) There is a heated debate with respect to the new whistleblower provisions contained in the Dodd-Frank Act, which greatly expands the SEC’s authority to grant bounty payments to persons who provide original information that leads to successful SEC enforcement and certain related actions. In November 2010, the SEC issued proposed implementation rules that would allow for awards that could range from 10 to 30 percent of the amount of monetary sanctions in cases over \$1 million. The SEC has acknowledged the concern that these new rules would encourage whistleblowers to circumvent a company’s internal compliance policy and has attempted to address this in its

WHAT additional responsibilities are assigned to audit committees by the NYSE?

The NYSE places the following additional responsibilities on audit committees:

- Companies listed on the NYSE must have an internal audit function. The audit committee has oversight over this function.
- Receive training from companies they serve with respect to the companies’ corporate governance guidelines.
- At least annually: (i) obtain and review a report by the independent auditor describing the independent auditor’s internal quality control procedures; (ii) review any material issues raised by the auditor’s most recent internal quality control review; and (iii) assess the auditor’s independence.
- Discuss earnings press releases, as well as financial information and earnings guidance that are given to analysts and ratings agencies.
- Set clear hiring policies for employees or former employees of the independent auditors.
- Report regularly to the board of directors.
- Perform an annual self-assessment.

proposal. However, the effectiveness of these proposed rules remains to be seen. The comment period closed December 17, 2010. (2) Furthermore, recent amendments to U.S. sentencing guidelines now provide organizations with an increased opportunity to reduce the penalties imposed for violations of the law if they have an effective compliance and ethics program in place. As a result of these and other developments, the volume of whistleblower claims is expected to increase dramatically. Thus, companies will most certainly want to get up to speed quickly and “shore up” their ethics and compliance

programs in response.⁴⁵ For further information, refer to future **Ac'sense**SM programming on these and other topics.

For further information on assessing whistleblower policies and oversight refer to BDO Consulting's Fraud Prevention Program at: <http://www.bdoconsulting.com/services/fraud-prevention-consulting.aspx>.

Additionally, within the appendix of the "Report of the NACD Blue Ribbon Commission on The Audit Committee" there is a sample whistleblower policy.⁴⁶

► AUTHORITY TO ENGAGE ADVISORS

UNDER WHAT CIRCUMSTANCES IS IT ADVISABLE FOR THE AUDIT COMMITTEE TO ENGAGE INDEPENDENT COUNSEL AND CONSULTANTS?

The SEC requires that audit committees have the authority to engage independent counsel and other consultants as they deem necessary to carry out their duties. While one cannot predict all of the scenarios in which the audit committee may need to engage third parties, it is highly advisable to develop these third-party relationships early on and, if possible, *before* their services may be needed to conduct an internal investigation or in conjunction with significant business transactions or other matters. This becomes particularly important when confronted with instances of suspected or known fraud for which independent investigations may need to be assembled expeditiously.

In cases of suspected or discovered illegal or fraudulent activities, the audit committee may also consider the need to engage forensic accountants to provide a variety of skills with respect to proficiencies in accounting, investigative skills, computer technology and data analysis, interviewing, and litigation support. Legal counsel as well as public relations specialists are additional examples of third party service providers often consulted in contemplation of business transactions or in times of crisis. Whenever use of third party services is being considered, the audit committee should bear in mind the following best practices prior to engagement:

- Evaluate skills, competence and experience of service provider
- Evaluate independence/objectivity of service provider
- Establish specific roles/responsibilities of management, audit committee and service provider with respect to issue being addressed
- Document agreement between audit committee and service provider regarding execution of services to be provided, timing of services and fees to be paid

It is important to note that regardless of any outside assistance that the audit committee may engage, the audit committee has ultimate responsibility. It should be proactive by taking the lead in investigations

into alleged fraudulent activity and illegal acts to ensure that the evaluation of such matters is escalated and receives immediate attention, is properly communicated to all parties involved and that investigations are executed properly and timely. For further guidance on this, please refer to BDO's practice aid on *Effective Mechanisms for Reporting, Investigating and Remediating Fraud* within the **Appendix** as well as to BDO's **Ac'sense**SM *Internal Investigations* archived webcast at: <http://www.bdo.com/acsense/events/InternalInvestigations.aspx>.

For further information on how BDO Consulting's investigations and compliance practice may be able to assist those charged with governance (i.e., audit committees), refer to: <http://www.bdoconsulting.com/services/consultingservices.aspx>.

Funding

The issuer must provide appropriate funding for the audit committee to compensate the outside auditors and any independent counsel and advisors it engages and to fund ordinary administrative expenses of the audit committee that are necessary in carrying out its duties.

In this regard, to quote from the SEC's final standard relating to listed company audit committees⁴⁷: "An audit committee's effectiveness may be compromised if it is dependent on management's discretion to compensate the independent auditor or the advisors employed by the committee..." Requiring the issuer to provide for appropriate funding "will further the standard relating to the audit committee's responsibility to appoint, compensate, retain and oversee the outside auditor. It also will add meaning to the standard relating to the audit committee's authority to engage independent advisors. Not only could an audit committee be hindered in its ability to perform its duties objectively by not having control over the ability to compensate these advisors, but the role of the advisors also could be compromised if they are required to rely on management for compensation. Thus, absent such a provision, both the audit committee and the advisors could be less willing to address disagreements or other issues with management."



▶ THE WHENS

WHEN SHOULD THE AUDIT COMMITTEE MEET WITH MANAGEMENT, INTERNAL AUDIT, AND THE INDEPENDENT AUDITORS?

We recommend that audit committees establish a timeline for essential meetings yet be flexible and be willing to meet more frequently as circumstances warrant or as issues arise. At a minimum, we recommend that the audit committee, together with management and the independent auditors, meet at least five times per year: the start of the annual audit; at the end of the audit to discuss its results; as well as once a quarter to discuss the results of interim reviews. These meetings should precede the Company's press releases. In addition, audit committees should meet formally with internal auditors at least twice a year – once to discuss the internal audit plan and once to discuss the results of the internal audit work. The audit committee is encouraged to hold executive sessions with the auditors, without management present, as often as deemed necessary. We further encourage more frequent contact between meetings between the audit committee and relevant parties, as circumstances warrant.

Who is required to attend and the frequency and duration of such meetings should be adjusted on an as needed basis to address risks and complexities faced by the company. Ample time should be reserved during the meetings so that the audit committee may speak freely and candidly with each of these parties and plan for executive or separate sessions (see following discussion) in which the audit committee may speak directly to these individual groups without the others present. To underscore the importance of the initial planning meeting in setting the tone and understanding with the auditors, the planning meeting typically would address the following items:

- The auditor's proposed audit plan and scope, including areas they have identified as key risk areas;
- Expectations of the audit committee as to areas of focus or procedures they would like to have the auditors address;

- Expectations of what kind of items, in addition to those required, that the audit committee would like to have the auditors communicate back to them;
- A timeline for meetings, deliverables and other communications; and
- Agreement as to the format of items to be reported to the audit committee (e.g., verbal, written or both).

It should be noted that the resulting audit plan and scope that are developed at the planning phase are not static and changes to this plan as a result of circumstances (either anticipated or otherwise) may dictate the need for additional meetings with the external auditors. The same risk management concept holds true for sessions with management and the internal auditors (see following section). These planning meetings, thus, serve as a good reference/check to refer to in future meetings to ensure that the risks identified either prior to the audit or as the year progresses are being addressed timely and that the audit is tracking according to plan and findings are being handled timely to reduce the likelihood that "surprises" are uncovered in the wrap-up phase of the reporting period. As a further point, if regularly scheduled meetings do not cover the results of the auditor's "management letter"⁴⁸ or matters discussed in conjunction with audits of internal control over financial reporting, we recommend that an additional meeting be scheduled to encompass noted areas for improvement. Please refer to the [Appendix](#) for a sample of BDO's *Model Audit Committee Meeting Agendas* which provides a recommended timeline for various meetings including objectives, action planning and reporting to the board of directors.

Now, let's turn to the HOWs of an effective audit committee...



▶ THE HOWS

HOW SHOULD AN EFFECTIVE AUDIT COMMITTEE BE GOVERNED?

The NYSE, NYSE AMEX, and NASDAQ require all listed companies to have an audit committee **charter**. As such, an audit committee should adopt a formal written charter that is focused on the mission of the audit committee. The charter should document the scope of the audit committee's specific responsibilities, how those responsibilities are carried out, and the audit committee's membership requirements. Rather than a "check the box" type of document, the primary purpose of the charter is to create a practical roadmap to help the audit committee achieve its goals. Thus, drafting a seemingly endless list of responsibilities may actually be counterproductive.

The sample *Audit Committee Charter* provided in the **Appendix** is for illustrative purposes only. As such, it may be a useful starting point for an audit committee to use in developing its own charter. In addition, we also recommend consideration of the AICPA's *Audit Committee Charter Matrix*, which is available within the Audit Committee Toolkit accessible from the AICPA's Audit Committee Effectiveness Center at: <http://www.aicpa.org/ForThePublic/AuditCommitteeEffectiveness/Pages/ACEC.aspx>.⁴⁹ The audit committee charter represents a "living" document that audit committees may use in managing their meeting agendas.

In addition, we have created a document aimed at providing a roadmap of the audit committee's specific responsibilities with regard to charters and a listing of other useful resources within our *Audit Committee*

Charters – Roadmap and Resources publication, also included within the **Appendix**.

As an additional resource, many of the concepts that we have outlined within this publication specifically for audit committees are echoed by a publication issued by the NACD aimed more broadly at boards of public entities entitled "*The Key Agreed Principles to Strengthen Corporate Governance for U.S. Publicly Traded Companies*" available at: <http://www.nacdonline.org/keyprinciples>.

HOW MUCH TIME SHOULD AN AUDIT COMMITTEE MEMBER EXPECT TO SPEND ON COMMITTEE WORK?

The complexity of the company's activities, its stage of development and magnitude of its issues will determine the audit committee's agenda. In addition, familiarity and experience of the audit committee members with the company's operations are important factors in determining adequate time allotment. On average, the audit committee should plan for at least six meetings per year but that number may be on the "lighter" side, as discussed previously. The audit committee should meet to discuss scheduled matters, such as planning, quarterly financial information and the year-end audit but be prepared to schedule ad hoc sessions as circumstances warrant. Most audit committees try to schedule their meetings to coincide with regular meetings of the board, which may result in a more effective use of time. However, be wary of meetings that are squeezed into other agendas as

this is usually an ineffective practice and it sends the wrong message as to the tone at the top.

Further thoughts about audit committee meetings and suggestions for their agendas are outlined in Model Audit Committee Meeting Agendas within the [Appendix](#).

HOW DOES ONE MAXIMIZE THE BENEFITS IN CONDUCTING AUDIT COMMITTEE MEETINGS?

Audit committee meetings need to be well organized. The audit committee needs to participate in the agenda-setting process up front along with other appropriate individuals (e.g., external and internal auditors and management), and the audit committee chair needs to preside over these meetings to ensure adherence to this agenda. Agendas should focus on the following:

- Risk management
- Accounting judgment/estimates and disclosures
- Information technology (IT) governance
- Internal controls
- Internal and external auditor effectiveness
- Legal/regulatory compliance

Receiving and reviewing meeting materials prior to audit committee meetings is an effective and efficient way to ensure that the high priority items get covered in the time allotted. A related best practice is to request highlighted materials in advance of meetings that focus on what has changed at a top-level so that audit committee members do not get "lost in the details." Supporting detail should also be provided, particularly with regard to complex areas, for review.

Holding audit committee "executive sessions" is another best practice. Executive sessions are one-on-one meetings held between the audit committee and separately with key members of management, the internal audit function, and the external auditors. These sessions give the audit committee the opportunity to direct questions to individuals that may be awkward for the respondents to answer in the presence of others.

Within the [Appendix](#), we have included *Sample Audit Committee Questions to Ask of Auditors and Management*, a suggested listing of common questions that the audit committee may pose to management and auditors during its periodic meetings. In addition, within its Audit Committee Toolkit, the AICPA provides illustrative questions for audit committees to ask during executive sessions with management, the internal auditors, and the external auditors. The Toolkit is accessible from the AICPA's Audit Committee Effectiveness Center at: <http://www.aicpa.org/ForThePublic/AuditCommitteeEffectiveness/Pages/ACEC.aspx>.⁵⁰

NACD's "Ten Principles of Effective Audit Committee Oversight"

The NACD Blue Ribbon Commission on the Audit Committee recommends the following principles that they believe provide "a foundation for engaged, effective audit committee oversight":

1. Be proactive in focusing the agenda on what's important – *financial reporting risk* – and make the most of audit committee meetings.
2. Insist on transparency, both external transparency and internal transparency – among the audit committee, management and the internal and external auditors.
3. Focus closely on external financial communications – beyond the 10-K and 10-Q.
4. Question the continuing validity of assumptions that underlie critical accounting judgments and estimates, and be up-to-speed on key financial reporting issues and developments affecting the company.
5. Assess the audit committee's role in the oversight of risk management, with an eye to clarifying the scope.
6. Set clear expectations for the external and internal auditors.
7. Make sure the CFO and the entire finance organization, as well as internal audit, have what they need to succeed, and be sensitive to the strains on these organizations.
8. Assess the tone at the top and throughout the organization, including the effectiveness of compliance and anti-fraud programs.
9. Help link change and risk management, and monitor critical alignments (controls and risks).
10. Take a hard look at the audit committee's effectiveness, including its composition and leadership, and find ways to continuously improve.

Source: "2010 Report of the NACD Blue Ribbon Commission on The Audit Committee" available for purchase at: <http://www.nacdonline.org/>

BDO INSIGHT

Principle 4 of the 2010 NYSE Commission Report on Corporate Governance indicates: "Good corporate governance should be integrated with the company's business strategy and objectives and should not be viewed simply as a compliance obligation separate from the company's long-term business prospects."⁵¹ Audit committees are cautioned against falling into a checklist mentality where the basic goal is completion of the checklist itself, rather than conducting their own company-specific investigation. Accordingly, questions should be tailored to the circumstances of each company.

HOW SHOULD AN AUDIT COMMITTEE EVALUATE ITS OWN EFFECTIVENESS?

We believe that an audit committee should conduct an annual assessment of its own effectiveness.⁵² There are a number of ways to conduct this self-assessment. We recommend that audit committee members complete a questionnaire such as the *Audit Committee Self-Assessment* practice aid we have provided within the [Appendix](#). The topics and issues for consideration within this questionnaire have been developed in conjunction with this publication, review of other widely available self-assessment tools and our knowledge and experience in working with both public company audit committees and private company committees charged with governance.

As there is always room for improving quality and performance, we recommend that the *Audit Committee Self-Assessment* practice aid be used in conjunction with your organization's Audit Committee Charter (or similar document) to ensure that governance responsibilities are adequately aligned with the charter and are being fulfilled appropriately. You may choose to customize this self-assessment further to reflect specific attributes of your organization and develop specific action steps and estimated completion dates to enhance your committee's performance.

Additionally, the AICPA Audit Committee Toolkit contains a sample questionnaire accessible from the AICPA's Audit Committee Effectiveness Center at: <http://www.aicpa.org/ForThePublic/AuditCommitteeEffectiveness/Pages/ACEC.aspx>.⁵³

In addition to using the *Audit Committee Self-Assessment* practice aid, audit committee members may consider further performing evaluations of each other (with or without assistance from third-party consultants) and seek specific feedback from members of management, the external auditors, and the internal auditors. Honest self-assessments may uncover the need for a change in the composition of committee members to meet the strategic needs of the company.

As mentioned previously, the audit committee charter should be viewed and used as a working/living document. Thus, as part of the

audit committee's assessment of itself, the audit committee charter should also be updated, as necessary.

HOW SHOULD AN AUDIT COMMITTEE REMAIN CURRENT WITH REGARD TO TECHNICAL GUIDANCE?

The complexity and proliferation of today's financial accounting and reporting guidance is mind-boggling. Continuing education of audit committee members is imperative to their effectiveness. This responsibility does not just reside with the designated "financial expert" but rather is shared by all members of the audit committee. We recommend periodic meetings between the audit committee and the external auditors, particularly the engagement partner, be scheduled to highlight issuances of new accounting and reporting standards and other "hot topic" areas and what the anticipated impact may mean to the company in light of consummated or contemplated business transactions. As part of the [Ac'senseSM](#) program, BDO offers periodic webinars aimed at breaking down complex accounting and reporting issues to a digestible level for financial executives, management and audit committee and board members. For a current listing of upcoming programs along with archived webcasts and self-study courses, please visit <http://www.bdo.com/acsense/> or speak with your BDO audit engagement teams.

HOW SHOULD AN AUDIT COMMITTEE REPORT ITS RESPONSIBILITIES AND ACTIVITIES TO INVESTORS?

Audit committees are required to issue a report in connection with the company's annual proxy statement. In this report, audit committees must state whether they have:

- Reviewed and discussed the audited financial statements with management;
- Discussed with the independent auditors the matters required to be communicated (Refer to *Auditor Required Communications with Audit Committees* within the [Appendix](#));
- Received the written disclosures and the letter from the independent auditors required by PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*, and has discussed with the independent accountant the independent accountant's independence; and
- Recommended to the board of directors that the audited financial statements be included in the company's Annual Report on SEC Form 10-K.

Audit committees may also want to consider making additional disclosures to the public with respect to their involvement with non-recurring transactions or special investigations – some of which may entail the audit committee engaging other advisors.



► CONCLUSION

WE HAVE COVERED A LOT OF GROUND. THE MARKETPLACE, IN WHICH COMPANIES AND THEIR AUDIT COMMITTEES FUNCTION, CONTINUES TO EVOLVE AND CHANGE.

You now must ask yourselves: Is your organization prepared to meet the challenges that lay ahead for those in corporate governance positions to **oversee** your company in achieving its goals and meeting its responsibilities to shareholders and the regulatory community? As the rules of the marketplace continue to be enhanced, risks grow, and the financial, economic and ethical pressures continue to mount, the audit committees' responsibilities widen and take on even more significant meaning in ensuring the health and longevity of the companies and boards that they serve.

We hope you have found "*Effective Audit Committees in the Ever Changing Marketplace*" a helpful tool in directing you toward the important questions to be asked to better assist you in understanding the significant role of the audit committee and the positive impact it can have on a company.



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▶ AUDIT COMMITTEE CHARTERS – ROADMAP TO SPECIFIC DUTIES AND RESPONSIBILITIES

Specific Duties and Responsibilities	Source
CORPORATE GOVERNANCE	
<ol style="list-style-type: none"> 1. Disclose annually whether or not the audit committee has a charter and, if so, provide a copy of the charter in the proxy, unless posted within the company's website. 2. Disclose annually whether or not the audit committee contains at least one financial expert (as defined) and if not, why not. 	SEC requirements
<ol style="list-style-type: none"> 3. Adopt a written charter. The charter must contain the audit committee's scope, structure and process. Audit committees must review and update their charters annually. The audit committee must be evaluated annually and must report annually on whether it has fulfilled its responsibilities under the charter. 4. Consist of at least three members, who must be financially literate, one member must be a financial expert. 5. Have authority to investigate any matter. 	Exchange listing requirements or best practices
OVERSIGHT OF FINANCIAL REPORTING	
<ol style="list-style-type: none"> 1. Include a report in each annual proxy. The required disclosures include: <ul style="list-style-type: none"> • Whether the audit committee discussed the annual financial statements with management. • Whether the audit committee discussed with external auditors the matters required to be discussed by SAS 61 (and any subsequent revisions). • Whether the audit committee received the external auditor's disclosure regarding independence which is required by PCAOB Rule 3526 (and any subsequent modifications). • Whether based on review and discussion of the preceding three items, the audit committee recommends to the board of directors that the audited financial statements be included in the company's annual report. 	SEC requirements
<ol style="list-style-type: none"> 2. Review and discuss annual and quarterly statements and MD&A with management and auditors. 3. Review earnings releases and guidance provided to rating agencies. 4. Approve all related party transactions. 	Exchange listing requirements or best practices
OVERSIGHT OF AUDITORS	
<ol style="list-style-type: none"> 1. Be responsible for the appointment and compensation of the external auditor. 2. Oversee the external auditor's work, including resolution of any disagreements between the auditor and management on financial reporting. 3. Pre-approve audit and nonaudit services provided by the external auditor. 4. Review reports submitted by the external auditor, including the auditor's reports on critical accounting policies and practices, alternative treatments discussed with management and their ramifications, and the auditor's preferred treatment. The auditor must report other material written communications with management, such as management letters or schedules of unadjusted differences. 	SOX requirements
<ol style="list-style-type: none"> 5. Ensure external auditor is accountable to both board and audit committee. 6. Ensure auditor independence. 7. Oversee the internal audit function. 8. Ensure open communication and information flow with management and auditors. 	Exchange listing requirements or best practices
OVERSIGHT OF COMPLIANCE, ETHICS AND CONTROLS	
<ol style="list-style-type: none"> 1. Review reports submitted by management. (Management must disclose to both the auditors and the audit committee significant deficiencies and material weaknesses in the design of internal controls that could adversely affect the company's ability to record, process, summarize, and report financial data. They must also disclose any fraud involving management or others who have a significant role in internal controls.) 2. Provide procedures to receive, retain, and treat complaints, as well as procedures to confidentially handle employee complaints (whistle-blower protection). 	SOX requirements
<ol style="list-style-type: none"> 3. Monitor system of compliance with legal and regulatory requirements. Oversee internal audit function. Oversee system for compliance with ethical codes. 	Exchange listing requirements or best practices

► ILLUSTRATIVE AUDIT COMMITTEE CHARTER

The following illustrative Audit Committee Charter is intended as an example to assist the audit committee in constructing its own company-specific¹ charter that will be used as a working document or practical roadmap to outline its responsibilities and required duties. The charter should be assessed continually, but at least annually, to ensure that it captures and portrays the role of the audit committee accurately.

Note: The information below may further be converted to a matrix to allow listing of specific action steps and defined deliverable dates.

COMMITTEE ROLE

The committee's role is to act on behalf of the board of directors and oversee all material aspects of the company's financial reporting, internal control and audit functions, except those specifically related to the responsibilities of another standing committee of the board. The audit committee's role includes a particular focus on the qualitative aspects of financial reporting to shareholders and on company processes for the management of business/financial risk and for compliance with significant applicable legal, ethical and regulatory requirements. The role also includes coordination with other board committees and maintenance of strong, positive working relationships with management, external and internal auditors, counsel and other committee advisors.

COMMITTEE MEMBERSHIP

The committee shall consist of at least three independent, non-executive board members. Committee members shall have: (1) knowledge of the primary industries in which the company operates; (2) the ability to read and understand fundamental financial statements, including a company's balance sheet, income statement, statement of cash flows and key performance indicators; and (3) the ability to understand key business and financial risks and related controls and control processes. The committee shall have access to its own counsel and other advisors at the committee's sole discretion. At least one member, preferably the chair, should be literate in business and financial reporting and control, including knowledge of the regulatory requirements, and should have past employment experience in finance or accounting or other comparable experience or background and shall be deemed "an audit committee financial expert"². Committee appointments shall be approved annually by the full board upon recommendation of the nominating committee. The committee chairperson shall be selected by the committee members or by the nominating committee.

COMMITTEE OPERATING PRINCIPLES

The committee shall fulfill its oversight responsibilities within the context of the following overriding principles:

Communications

The chair and others on the committee shall, to the extent appropriate, maintain an open avenue of contact throughout the year with senior management, other committee chairs and other key committee advisors (e.g., external and internal auditors, etc.), as applicable, to strengthen the committee's knowledge of relevant current and prospective business issues.

Education/Orientation

The committee, with management, shall develop and participate in a process for review of important financial and operating topics that present potential significant risk to the company. Additionally, individual committee members are encouraged to participate in relevant and appropriate education to ensure understanding of the business and environment in which the company operates.

Annual Plan

The committee, with input from management and other key committee advisors, shall develop an annual plan responsive to the "primary committee responsibilities" detailed herein. The annual plan shall be reviewed and approved by the full board.

¹ In constructing its charter, the audit committee needs to consider the specific responsibilities and requirements of the audit committee as outlined under SEC rules as well as the Company's respective listing exchange and should include consideration of additional facts and circumstances specific to the Company.

² As defined under applicable SEC rules.

► ILLUSTRATIVE AUDIT COMMITTEE CHARTER continued

Meeting Agenda

Committee meeting agendas shall be the responsibility of the committee chair, with input from committee members. It is expected that the chair will also ask for management and key committee advisors, and perhaps others, to participate in this process.

Expectations and Information Needs

The committee shall communicate committee expectations and the nature, timing and extent of committee information needs to management, internal auditors and external parties, including external auditors. Written materials, including key performance indicators and measures related to key business and financial risks, shall be received from management, auditors and others at least one week in advance of meeting dates. Meeting conduct will assume committee members have reviewed written materials in sufficient depth to participate in committee/board dialogue.

External Resources

The committee shall be authorized to access internal and external resources, as the committee requires, in carrying out its responsibilities. This includes the authority to hire and terminate internal and external auditors and advisors, as well as the responsibility to approve services and fees paid to such resources.

Meeting Attendees

The committee shall request members of management, counsel, internal and external auditors, as applicable, to participate in committee meetings, as necessary, to carry out the committee's responsibilities. Periodically and at least annually, the committee shall meet in private sessions with only the committee members. It shall be understood that meetings between the committee and/or the committee chair with either internal or external auditors, or counsel, may, at any time, be deemed necessary, with or without management's attendance. In any case, the committee shall meet in executive sessions separately with internal and external auditors, at least annually.

Meeting Frequency

The committee shall meet at least quarterly. Additional meetings shall be scheduled as considered necessary by the committee or chair.

Reporting to the Board of Directors

The committee, through the committee chair, shall report periodically, as deemed necessary, but at least semiannually, to the full board. In addition, summarized minutes from committee meetings, separately identifying monitoring activities from approvals, shall be available to each board member at least one week prior to the subsequent board of director's meeting.

Self-Assessment

The committee shall review, discuss and assess its own performance as well as its role and responsibilities, seeking input from senior management, the full board and others. Changes in role and/or responsibilities, if any, shall be recommended to the full board for approval.

COMMITTEE RESPONSIBILITIES

Financial Reporting

- Discuss, review and assess the annual and interim financial statements with management and the auditors before they are released to the public or filed with the SEC and formally recommend to the board that the audited annual financial statements be included within the company's annual report filed with the SEC.
- Discuss, review and assess the key financial statement issues and risks, their impact or potential effect on reported financial information, the processes used by management to address such matters, related auditors' views, and the basis for audit conclusions.
- Approve changes in important accounting principles and the application thereof in both interim and annual financial reports.
- Advise financial management and the auditors that they are expected to provide a timely analysis of significant current financial reporting issues and practices.

Risks and Controls

- Review and assess the company's business and financial risk management process, including the adequacy of the overall control environment and controls in selected areas representing significant risk.

► ILLUSTRATIVE AUDIT COMMITTEE CHARTER continued

- Review and assess the company's system of internal controls for detecting accounting and financial reporting errors, fraud and defalcations, legal violations, and noncompliance with the corporate code of conduct. In that regard, review the related findings and recommendations of the external and internal auditors, together with management's responses.
- Review with legal counsel any regulatory matters that may have a material impact on the financial statements.
- Review the results of the annual audits of directors' and officers' expense accounts and management perquisites prepared by the internal auditors.

External and Internal Auditors

- Recommend the selection of the external auditors for approval by the board of directors.
- Instruct the external auditors that they are responsible to the board of directors and the audit committee as representatives of the shareholders. In that regard, confirm that the external auditors will report all relevant issues to the committee in response to agreed-upon expectations.
- Review the performance of the external and internal auditors.
- Obtain a formal written statement from the external auditors consistent with standards set by the Public Company Accounting Oversight Board. Additionally, discuss with the auditors any relationships or nonaudit services that may affect their objectivity or independence.
- Consider, in consultation with the external and internal auditors, their audit scopes and plans to ensure completeness of coverage, reduction of redundant efforts and the effective use of audit resources.
- Review and pre-approve requests for any audit-related or permitted non-audit services to be performed by the external auditors, and be advised of any other study undertaken at the request of management that is beyond the scope of the audit engagement letter.
- Review with management and the external auditors the results of the annual audits and related comments in consultation with other committees as deemed appropriate, including any difficulties or disputes with management, any significant changes in the audit plans, the rationale behind adoptions and changes in accounting principles, and accounting estimates requiring significant judgments.
- Provide a medium for the external auditors to discuss with the audit committee their judgments about the quality, not just the acceptability, of accounting principles and financial disclosure practices used or proposed to be adopted by the company.
- Discuss the significant findings of the audit including:
 - Critical accounting policies and practices used by the company;
 - Alternative accounting treatments within generally accepted accounting principles related to material items that have been discussed with management; and
 - Other material written communications between the accounting firm and management (e.g., management representation letters, engagement letters, etc.).
- Review with the external auditor the audit firm's quality control policies and procedures and any material issues raised by the most recent internal quality control review of the firm.
- Approve changes in the directors of the internal audit function.
- Instruct the internal auditors that they are responsible to the board of directors through the committee.
- Review with the internal auditors any changes in the scope of their plans.
- Review with the internal auditors the results of their monitoring of compliance with the code of conduct.

Other

- Establish and monitor procedures for the receipt, retention and treatment of complaints received by the company regarding accounting, internal accounting controls or auditing matters, including procedures for the confidential, anonymous submission by employees of the company of concerns regarding questionable accounting or auditing matters.
- Prepare the required audit committee report to be included within the company's annual proxy statement.
- Review and update the committee's charter at least annually.
- Review and update the company's code of conduct.
- Review and approve significant conflicts of interest and related party transactions.
- Conduct or authorize investigations into any matter within the committee's scope of responsibilities. The committee will be empowered to retain independent counsel and other professionals to assist in conducting any investigation.

► MODEL AUDIT COMMITTEE MEETING AGENDAS

The following Model Audit Committee Meeting Agendas suggest the timing, objectives, specific actions to be performed, and communications to be made to the board for certain audit committee meetings. The agendas were prepared assuming a six-meeting schedule, and are not intended to be all-inclusive. Rather, meetings should reflect the Company's specific circumstances and the audit committee's particular concerns. Meetings typically begin with a discussion of matters of mutual interest among the audit committee, management, and external and internal auditors. The audit committee may then meet privately with each to discuss candidly sensitive or confidential matters. It may also be appropriate for Company counsel and/or outside counsel to attend certain meetings. Material to be discussed at meetings should be clearly prepared and sent to the committee members in sufficient time for them to digest it, so the actual meeting time can be used most productively. While the audit committee's activities should be carefully planned, its operating structure should not be immutable. Even if the Company's business has not changed recently, the audit committee should re-examine its duties and performance level over the last year. This regular self-assessment and review of the audit committee charter¹ should be built into the meeting calendar.

QUARTERLY REVIEW MEETINGS

Timing

Before the release of earnings or as soon thereafter as practical.²

Meeting Objectives

To discuss with the external auditors the impact of significant matters noted in the review of the interim financial information.

Action

Ensure pre-approval of audit and permitted non-audit services *prior* to any work being performed.³

Discuss any of the following matters as they relate to the interim financial statements:

- Any significant new changes in accounting policies, including their quality (not just their acceptability)
- Management judgments and accounting estimates
- Significant adjustments made or proposed
- Other information contained in documents containing the financial statements
- Disagreements with management
- Consultation with other auditors
- Difficulties encountered in performing the review

Report to Board

Describe permitted non-audit services to be provided by the external auditors and conclude whether such services could impair independence. Communicate any significant items identified by the external auditors as a result of their review procedures.

¹ Refer to the BDO Audit Committee Self-Assessment and Illustrative Audit Committee Charter practice aids.

² Due to tight time constraints, these meetings may be conducted telephonically.

³ Normally done during the first quarter.

► MODEL AUDIT COMMITTEE MEETING AGENDAS *continued*

AUDIT PLANNING MEETING

Timing

Several weeks or months before the start of the audit.

Meeting Objectives

To review the external auditors' integrated audit plan and anticipated non-audit services, and the scope and activities of the internal auditors for the past year. Consider the following:

Risks and Internal Controls

- Business and financial risks identified by management and the auditors
- Management override
- Industry conditions
- External auditors' most recent management letter
- Problem areas noted in prior year's audit
- Sensitive matters
- Internal auditors' reports

Audit Scope in Light of Current Business Circumstances

- Accounting and auditing developments
- Significant changes in Company activities
- Changes in accounting policies
- Audit timing
- Locations to be examined
- Personnel being assigned to the audit
- Assistance to be provided by the internal auditors
- Involvement of other auditors
- Planned reliance on internal accounting controls (including computer security programs) to be used in conjunction with the integrated audit
- Use of computer assisted auditing techniques
- Areas for special procedures
- Review for fraud or other improprieties
- Rotation of audit procedures
- Estimated audit fees
- Proposed non-audit services
- Comparison of operating results with prior year

Action

Approve external auditors' integrated audit plan and the scope of the internal audit plan..

Report to Board

Discuss any issues carried over from the prior year; describe scope and timing of the integrated audit, which includes internal control over financial reporting; highlight all significant matters affecting the financial statements; describe non-audit services to be provided by the external auditors; and conclude whether such services could impair independence.

► MODEL AUDIT COMMITTEE MEETING AGENDAS *continued*

PRE-EARNINGS RELEASE MEETING

Timing

At or near completion of the audit and before the earnings release.

Meeting Objectives

To review the audit findings, the drafts⁴ of the financial statements, and (if available) the annual stockholders' report. Consider the following:

Review of Audit

- Deviations from audit plan
- Accounting and auditing developments
- Difficulties or delays
- Auditors' judgment about the quality of the accounting policies and financial disclosure practices
- Significant matters and discoveries
- Restrictions encountered
- Unresolved matters
- Disagreements with management
- Significant audit adjustments and those waived because of immateriality
- Significant deficiencies and material weaknesses identified
- Independence issues

Review of Preliminary Draft of Financial Statements

- The auditors' responsibility under generally accepted auditing standards
- Management's significant judgments and accounting estimates
- Significant audit adjustments made or waived
- Other information in documents containing the audited financial statements
- Timing of release

Action

Approve audit findings, earnings release and preliminary draft of annual financial statements.

Report to Board

Discuss conduct and findings of the audit; significant deficiencies and material weaknesses identified; any disagreements between external auditors and management; and recommend release of earnings and clear draft of basic financial statements.⁴

⁴ This represents the basic financial statements themselves and not the corresponding notes to the financial statements which may not be ready at this point in time and would typically be discussed during the post earnings release meeting.

► MODEL AUDIT COMMITTEE MEETING AGENDAS *continued*

POST-EARNINGS RELEASE MEETING

Timing

After the release of earnings, upon availability of a draft of Form 10-K and receipt of external auditors' management letter.

Meeting Objectives

To review the year's work and recommended improvements in internal controls not otherwise communicated; approve internal audit plan for coming year; and recommend external auditors for the coming year.

Review of Form 10-K and Auditors' Report

- Completeness and transparency of disclosures, including risks and uncertainties
- Consistency of annual report text with financial statements
- Wording of auditors' report – qualifications or modifications

Review of Internal Controls

- Management's assessment of internal controls and suggested changes
- External auditors' management letter recommendations
- Internal auditors' recommendations and audit plan for next year

Performance Review

- Evaluation of external auditors by:
 - Management
 - Internal auditors
- Retrospective review of prior year's quarterly reviews and integrated audit to determine how to improve efficiency and effectiveness
- Evaluation of internal auditors and staff by external auditors
- Evaluation of financial and accounting personnel by external auditors
- Recommendations from all parties for improvements in audit approach and financial disclosure
- Review of auditors' fees for the work performed
- Self-assessment of audit committee and review of charter⁵

Action

Follow up with management as to improvements to be made to internal controls and changes in accounting methods, approve internal audit plan for the coming year and decide upon the recommendation of external auditors to the board.

Report to Board

Summarize the year's work including recommended improvements in internal controls or changes in accounting methods; discuss reporting issues; recommend external auditors for the coming year; and recommend changes to the audit committee charter, as necessary.

⁵ Refer to separate BDO Audit Committee Self-Assessment and Illustrative Audit Committee Charter practice aids.

▶SAMPLE AUDIT COMMITTEE QUESTIONS TO ASK OF AUDITORS AND MANAGEMENT

To assist the audit committee in performing its duties, the following is a list of questions they may ask the auditors and management in the context of periodic discussions (i.e., audit planning meeting; quarterly review meetings; and pre- and post-earnings release meetings).¹ However, committees are cautioned against falling into a checklist mentality where the basic goal is completion of the checklist itself, rather than conducting their own company-specific investigation. Accordingly, these questions should be tailored to the circumstances of each company. You may find many of the following questions are appropriate to ask more broadly of both the auditors and management.²

AUDIT PLANNING MEETING

Ask the External Auditor

- Did you discuss any major accounting or auditing issues with management prior to your retention, your responses to which were, or might be considered to be, a condition of your retention?
- (If there is a new auditor this year) What steps will be taken to ensure an orderly transition from the prior auditor?
- What is the planned scope of your audit, i.e., will all of the subsidiaries be examined, what percentage of inventories will be observed, what percentage of accounts receivable will be confirmed, how will you verify accounts payable? Will auditing procedures be rotated (i.e., financial statement areas, locations, etc.)?
- Are there any subsidiaries or activities that will not be audited that present business or financial risks but are not viewed as "material?"
- How can your planned audit scope be relied upon to detect material errors, fraud, illegal acts or material weaknesses in internal control?
- How will the involvement of the internal auditor be coordinated with your integrated audit?
- Does the Company use the services of other external auditors? What is the percentage of assets, revenues and net income for which they will be responsible? How will you determine the quality of their work? Will your report make reference to the other external auditors?
- Are there any concerns with how management controls key business processes? Have the key processes been appropriately identified?
- Are there any areas where the Company could be of greater assistance to reduce the amount of time spent by you?
- Will your risk assessment of the internal control policies and procedures enable you to reduce audit testing performed in conjunction with the integrated audit?
- What risk assessment techniques will you use?
- What criteria do you use to determine materiality?
- How will you utilize computer auditing techniques to review our computer processes?
- Will you use statistical sampling?
- How does the planned scope of your integrated audit differ from the prior year?
- How do you intend to staff the engagement? Will there be personnel continuity from the prior year? What is the expected level of participation by the engagement partner?
- How do you plan to detect the existence of related party transactions?
- Are there any proposed accounting, auditing or reporting rules that could materially affect the Company's financial statements?
- Has the Company adopted any significant eBusiness strategies and if so how will you audit them?
- How do you ensure independence? Are there any matters that might reasonably be thought to bear on your independence?
- Are there any unresolved questions from the prior year's audit?
- Do you anticipate any special problems in this year's audit?
- (If applicable) Are there transition plans in place for the required rotation of the engagement partner (and/or the engagement quality review partner)?
- Did the PCAOB inspect our Company's audit? If so, were there any deficiencies noted?

¹ Audit committee may wish to refer to the BDO Financial Reporting Letter on *Shareholder Questions* available at: <http://www.bdo.com/publications/assurance/finrptnl/FRL-SQs-5-07.pdf> for additional questions to ask regarding specific accounting, financial reporting and governance matters.

² For additional questions for audit committees to consider with respect to IFRS, refer to *IFRS Implications for Audit Committees* available on the BDO IFRS Resource Center at: <http://www.bdo.com/ifrs/practice.aspx>

▶SAMPLE AUDIT COMMITTEE QUESTIONS TO ASK OF AUDITORS AND MANAGEMENT continued

AUDIT PLANNING MEETING

Ask the Internal Auditor

- Has management been responsive to your and the external auditor's previous findings and recommendations? What previous year internal control recommendations from either the external auditor or as a result of your procedures have not been adopted?
- Were there any areas of concern that were not reviewed due to budget or other limitations?
- Have your audits identified areas of concern to the overall corporate environment? Have any specific locations or areas been identified?
- Does management give appropriate consideration to your views?
- What is your relationship with the external auditors?
- How would you assess the information systems control environment, including key business information systems? How is security over these systems maintained?
- What work will you be doing to assist the external auditors? Could this work be expanded for greater audit efficiency?
- How do you monitor the Company's policies and procedures to prevent improprieties?
- What were the scope and results of internal audits this past year?
- How are risks identified?
- What procedures are in place to prevent/address the risk of management override of controls?
- How is the internal audit staff remaining current with respect to changes in accounting and financial reporting requirements? Are there appropriate training mechanisms in place?
- (For multi-locations) Do you and the external auditors plan to visit all of the Company's locations this year? If not, what are your criteria for site visits?

Ask Accounting Management

- Were there any major changes in operations this year?
- Are there any areas that require special attention due to high business or financial risks?
- What are the Company's policies and procedures to deter conflicts of interest and illegal acts, and how are they monitored?
- How does the Company minimize the risk of fraudulent financial reporting?³
- What are the Company's revenue recognition policies? Are there instances where we may be pushing the limit? Does the Company have bill and hold or consignment arrangements?
- Does the Company have any policies or practices to identify if any side agreements exist? Does the Company discourage the issuance of side agreements?
- Are there any major write-downs or other significant transactions that will affect the financial statements?
- Were there any significant changes in accounting estimates or models used in making accounting estimates? If yes, what changes were made and what are the financial statement effects?
- Is the Company contemplating any changes in accounting methods?
- Should the audit committee be aware of any problems or legal difficulties?
- Does management have the appropriate resources to assess the effectiveness of internal control over financial reporting?
- Are there policies and procedures in place for disclosing internal accounting control deficiencies and frauds or illegal acts identified to the auditors and the audit committee?
- How is management remaining current with respect to changes in accounting and financial reporting requirements? Are there appropriate training mechanisms in place?
- How do you define materiality? How is this different from the auditors' determination of materiality?
- Were there any significant systems implemented or modified that could impact processing of transactions?
- What is the company's current exposure to IFRS (i.e., statutory requirements, foreign subsidiaries, acquisition targets, significant competitors that currently report on IFRS)?
- What is the company's current level of IFRS knowledge? Does the company have adequate resources currently to begin to formulate a transition plan?
- Is management monitoring the status of IFRS standard-setting?
- Has management and the audit committee begun assessing risks to the company associated with application of IFRS throughout the organization?

³ For further audit committee guidance with respect to financial reporting fraud, refer to separate BDO practice aid entitled, "Strengthening Corporate Governance – Effective Fraud Programs."

▶SAMPLE AUDIT COMMITTEE QUESTIONS TO ASK OF AUDITORS AND MANAGEMENT continued

QUARTERLY REVIEW MEETINGS

Ask the External Auditor

- What are your procedures for ensuring audit committee pre-approval of audit and non-audit services?⁴
- What non-audit services do you expect to provide the Company and what are the approximate fees? How may performance of these services affect your independence?⁵
- What was the scope of the review?
- Are the accounting principles or financial reporting practices used by the Company only marginally acceptable? If so, what alternative principles or financial reporting would you recommend?
- Are there any accounting principles or financial reporting practices used by the Company acceptable only because their impact is not considered material to the financial statements? Might they cause a material impact in the future?
- Were there any changes made in significant accounting policies or their applications? If so, why were they made and what was the financial statement impact? Were there other alternatives that could have been selected?
- Are there any concerns about the Company's timely recognition of potential financial reporting issues or recognition of revenue?
- Was there any fraudulent financial reporting noted?
- Were there any disagreements with management and, if so, how were they resolved?
- Were there any consultations with other accountants?
- Were there any difficulties encountered in performing the review, including timing?
- Were any adjustments or disclosures proposed by you and not recorded by the Company?
- Are there any unresolved matters?
- Were there any unusual items that affected earnings? Are they properly accounted for and disclosed?
- Based upon your review procedures, are there any changes that should be made to the scope of the annual audit?

Ask the Internal Auditor

- Are you aware of any significant changes in internal control that might need to be reported in the 10-Q?
- Are you aware of any changes in processes for formulating any accounting estimates not discussed by the external auditors?
- Are you aware of any changes in accounting policies or their applications not reported on by the external auditors?

Ask Accounting Management

- What is the proposed audit fee for the current year and how does it compare to the prior year?⁶
- Were there any major changes in operations?
- What significant variances from the prior period and/or budgeted results occurred during the quarter, and what were the reasons?
- Were there any disagreements with the external auditors? If so, how were they resolved?

⁴ In practice, this discussion would typically be held early in the year prior to services being performed (e.g., first quarter).

⁵ See above footnote.

⁶ In practice, this discussion would typically be held earlier in the year in conjunction with approval of audit and non-audit services.

▶SAMPLE AUDIT COMMITTEE QUESTIONS TO ASK OF AUDITORS AND MANAGEMENT continued

PRE-EARNINGS RELEASE MEETING

Ask the External Auditor

- Did the scope of the audit differ from the audit plan?
- Were you provided with all the information you requested? Do you have any reason to believe that information was withheld from you or that management representations were incorrect?
- Did the Company or its counsel impose any limitations on you?
- Did you observe any areas of serious concern over the corporate control environment? Were any integrity or honesty concerns noted?
- Did you detect any material errors, fraud, illegal acts or significant deficiencies or material weaknesses in the internal control system?
- Were there any significant changes in financial statement amounts from the prior year? What were the causes of the changes?
- Did you have enough time to complete all phases of your audit? When do you expect to complete your audit?
- Will your opinion be unmodified? If not, why?
- (For multi-location engagements) How did you ensure that work performed by your audit firm in other locations has been pre-approved and does not impair independence?
- Did management consult with you on tax matters? Is the liability for taxes adequate to cover potential assessments?
- Did you provide any tax services to the Company or its executive officers of the type that would impair your independence under the PCAOB's rules on ethics and tax services?
- Were there any disagreements regarding accounting, auditing or reporting matters between you and management? If so, how were they resolved?
- Did management pressure you on contentious issues by threatening to "shop" for other auditors?
- Were any adjustments or disclosures proposed by you not recorded by the Company?
- Are there any unresolved matters?
- Are the accounting principles used by the Company overly conservative or aggressive? What would be the effect of using alternative principles? Do the accounting principles conform to industry practice?
- Were there any changes in accounting principles?
- How did you satisfy yourself as to the reasonableness of any significant accruals or estimates made by management (e.g., doubtful accounts, valuation allowances, environmental contingencies, etc.)?
- Were there any unusual items that affected earnings? Are they properly accounted for and will they be adequately disclosed?
- Did you review information furnished to other experts (e.g., actuaries)?
- Did you provide the Company with advice and assistance in reviewing the financial statements of merger candidates prior to their acquisition during the year? Are material risks and uncertainties properly accounted for and will they be adequately disclosed?
- Are you satisfied that there is no substantial doubt about the Company's ability to continue as a "going concern"?
- When do you expect to issue your report?
- Are there any significant concerns about information systems and their ability to process, record and report financial transactions?
- Did the Company enter into any contingent fee arrangements with you?

Ask the Internal Auditor

- What was the extent of your work on the audit and were there any changes to the scope of work performed?
- Was there adequate coordination with the external auditors?
- Did management impose any limitations on you?
- Were any significant problems encountered?
- Are you aware of any actual or possible illegal or questionable payments?
- Are you aware of any conflicts of interest between officers or employees and the Company?
- Are you aware of any significant deficiencies or material weaknesses in internal control not identified by management or the external auditors?

▶SAMPLE AUDIT COMMITTEE QUESTIONS TO ASK OF AUDITORS AND MANAGEMENT continued

PRE-EARNINGS RELEASE MEETING

Ask Accounting Management

- What was your reaction to the audit findings?
- Were there any disagreements between you and the external auditor? If so, how were they resolved?
- Are the financial statements fairly presented?
- What are the reasons for financial statement variations from the prior year?
- What was the substance of significant issues raised by either corporate or outside counsel, and how are these matters reflected in the financial statements?
- Did you consider any changes in accounting principles that were not ultimately adopted?
- Did you seek the opinions of other auditing firms on any accounting or auditing issues?
- Were there any significant fourth quarter adjustments and, if so, why weren't they made in earlier quarters?
- Were any problems or difficulties identified as a result of the audit that we should know about?
- What is your opinion of the auditing services performed by the external auditor?
- Were any significant deficiencies or material weaknesses identified and communicated to us pervasive across the Company or were they limited to a specific location or account? Have these been remediated?
- Were there any other deficiencies identified by you that were not reported to the audit committee (whether or not they have been remediated)?
- Were there any errors or adjustments noted by you that were not recorded?

POST-EARNINGS RELEASE MEETING

Ask the External Auditor

- Were there any related party transactions noted as a result of your audit? Are the transactions properly recognized and disclosed in the financial statements?
- How did you satisfy yourself that pending or threatened lawsuits are not likely to have a material effect on the financial statements? Has management provided adequate disclosures within the financial statements?
- In your review of other documents prepared by management (e.g., MD&A, CD&A, management's report on internal control over financial reporting, proxy statement, etc.), did you identify any inconsistencies or material misstatements of fact?
- What is management's attitude toward establishing strong internal controls? Do they set an effective example for the entire Company? Do they follow-up on suggested changes? Were weaknesses reported by you last year remediated? Was management receptive to your recommendations?
- Are there any material weaknesses in the Company's internal controls that have not been remediated, including computer security controls? Are appropriate changes being instituted?
- Did you encounter any difficulties in obtaining the management representation letter or any specific representations?
- What business advice do you have for the Company?
- How do you evaluate the Company's tax planning?
- What is your general assessment of the integrity and competence of the Company's financial, accounting, computer and internal audit staffs? Are they respected groups within the Company? Are they effective? What improvements would you recommend?
- How do actual engagement fees incurred for the year compare to the estimated fees?
- What percentage are the audit fees for this engagement in relation to your firm's total fees? Is that material?
- What can the Company do to reduce the audit time?
- What are the advantages to the Company in continuing its relationship with your firm?
- Are there any other items that should be discussed with the audit committee?

▶SAMPLE AUDIT COMMITTEE QUESTIONS TO ASK OF AUDITORS AND MANAGEMENT continued**POST-EARNINGS RELEASE MEETING****Ask the Internal Auditor**

- Are you aware of any related party transactions not disclosed in the financial statements?
- Are you aware of any management perquisites not included in officers' reported compensation?
- What are the department's goals and objectives for this year?
- What will be the scope of your activities this year?
- How will you monitor the Company's code of conduct?
- Do you feel your staffing is adequate?
- What additional work could you do to reduce the work of the external auditor?
- What is your evaluation of the external auditor's services for the past year?
- Are the Company's systems functioning with maximum efficiency at minimum cost?
- What is your assessment of the capabilities of management?
- Are there any other items that should be discussed with the audit committee?

Ask Accounting Management

- What is your reaction to the suggestions contained in the external auditor's management letter?
- What actions do you contemplate in response to these suggestions?
- What is your evaluation of the external auditor's services this past year?
- What significant changes do you foresee for the Company this year?
- Are there any other items that should be discussed with the audit committee?

► AUDITOR REQUIRED COMMUNICATIONS WITH AUDIT COMMITTEES

Communications for All Audits	Authoritative Guidance
An overview of planned scope and timing of audit	AICPA SAS 61 ¶102 AICPA SAS 114 ¶29-33
Auditor responsibility under generally accepted auditing standards (GAAS) and PCAOB Standards	AICPA SAS 61 ¶106 AICPA SAS 114 ¶26-28
Methods of accounting for significant unusual transactions and effects of policies in controversial or emerging areas (e.g., revenue recognition, off-balance sheet financing; and accounting for equity investments)	AICPA SAS 61 ¶107 AICPA SAS 114 Appendix B
Management judgments and accounting estimates	AICPA SAS 61 ¶108 AICPA SAS 114 ¶37-38 and Appendix B
Auditor's judgment about the quality of the company's accounting principles	AICPA SAS 90 ¶11 AICPA SAS 114 ¶37-38 and Appendix B
Adoption of or change in an accounting principle	AICPA SAS 61 ¶107 AICPA SAS 114 Appendix B
Material, corrected misstatements brought to the attention of management by the auditor	AICPA SAS 61¶109 AICPA SAS 114 ¶35
Unrecorded misstatements, other than those the auditor believes to be trivial	AICPA SAS 61¶109 AICPA SAS 114 ¶40-41
Other information in documents containing audited financial statements (e.g., MD&A)	AICPA SAS 61¶110 AICPA SAS 114 ¶28
Disagreements with management	AICPA SAS 61¶111 AICPA SAS 114 ¶42
Consultation with other accountants	AICPA SAS 61¶112 AICPA SAS 114 ¶43
Major issues discussed with management prior to retention (initial or recurring)	AICPA SAS 61¶113 AICPA SAS 114 ¶44
Significant issues discussed with management (i.e., business considerations, business plans and strategies)	AICPA SAS 114 ¶44
Significant difficulties encountered during the audit	AICPA SAS 61¶114 AICPA SAS 114 ¶39
Fraud and illegal acts	AICPA SAS 99 AICPA SAS 54
Representations requested from management	SEC Section 10A (k)(3) AICPA SAS 114
Other issues arising from the audit the auditor considers significant and relevant to those charged with governance	SEC Section 10A AICPA SAS 114 ¶34e
Significant deficiencies and material weaknesses identified during the audit/ integrated audit	PCAOB AS 5 and conforming amendments AICPA SAS 115
Independence	AICPA SAS 114 ¶45-47

► AUDITOR REQUIRED COMMUNICATIONS WITH AUDIT COMMITTEES continued

Additional Communications for Audits of Public Issuers	Authoritative Guidance
AC pre-approval of services	SEC Section 10A Audit Requirements (i)(1)(A)
Critical accounting policies and practices	SEC Section 10A Audit Requirements (k)(1) and FRR No. 60
Material alternative accounting treatments discussed with management	SEC Section 10A Audit Requirements (k)(2)
Other material written communications with management (e.g., management letters and schedules of material adjusted differences and unadjusted differences, if any, etc.)	SEC Section 10A Audit Requirements (k)(3)
Independence matters	PCAOB Rule 3526

Additional Communications for Integrated Audits	Authoritative Guidance
Scope of audit of internal control over financial reporting [for purposes of seeking audit committee pre-approval of service]	PCAOB Rule 3525 ¶a
Communication that the auditor has informed management of all deficiencies in internal control identified during the audit	PCAOB AS 5 ¶81
[If applicable] Communication that a material weakness(es) was (were) not disclosed or identified as such in management's assessment of internal control	PCAOB AS 5 ¶91 Note
[If applicable] Auditor's belief that the required disclosure about a material weakness is not fairly presented in all material respects within management's reporting on internal control	PCAOB AS 5 Appendix C ¶2
[If applicable] Auditor's conclusion that the audit of internal control over financial reporting cannot be satisfactorily completed and he or she cannot express an opinion because there has been a limitation on the scope of the audit	PCAOB AS 5 Appendix C ¶7
[If applicable] Additional information within management's report on internal control contains a material misstatement of fact	PCAOB AS 5 Appendix C ¶14
[If applicable] Auditor's belief that management's Section 302 disclosures about changes in internal control require modification	PCAOB AS 5 Appendix C ¶15

Additional Communications for Audits of NYSE Registrants	Authoritative Guidance
Auditor's internal quality-control procedures	NYSE Corporate Governance Standards – Section 303A.07(c)(iii)(A)
Material issues raised in quality control reviews w/in preceding 5 years and action taken	NYSE Corporate Governance Standards – Section 303A.07(c)(iii)(A)
Assess independence with regard to all relationships b/t auditor and the company	NYSE Corporate Governance Standards – Section 303A.07(c)(iii)(A)

► STRENGTHENING CORPORATE GOVERNANCE: EFFECTIVE MECHANISMS FOR REPORTING, INVESTIGATING AND REMEDIATING FRAUD

There are numerous resources available that guide those charged with governance (referred to as audit committees) toward building programs to include anti-fraud controls and cultivation of anti-fraud environments.¹ When put into place and followed, these programs go a long way in the prevention and deterrence of fraud. However, even when the strongest fraud prevention programs are in place and operating as designed, fraud may still occur. This practice aid is intended to briefly cover the key elements of an anti-fraud environment and responsibilities for such with emphasis on the structure, policies and procedures that audit committees need to ensure are in place *before* fraud occurs and the specific action steps to take *if and when* alleged fraud is suspected.

Let's first dispel some common misconceptions:

Myth: Handling alleged instances of fraud committed within an organization is solely the responsibility of company management.

Truth: Establishing effective mechanisms for the reporting, investigating and remediating of fraud is a shared responsibility with the company's audit committee:

Section 301 of the Sarbanes-Oxley Act specifically requires the audit committee *"to establish procedures for the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters."*

The SEC's interpretative guidance for management with respect to internal controls² states: *"Management's evaluation of the risk of misstatement should include consideration of the vulnerability of the entity to fraudulent activity (for example, fraudulent financial reporting, misappropriation of assets, and corruption), and whether any such exposure could result in a material misstatement of the financial statements. Management should recognize that the risk of material misstatement due to fraud ordinarily exists in any organization, regardless of size or type, and it may vary by specific location or segment and by individual financial reporting element..."* While the SEC's guidance does not specifically address the role of the audit committee, it does note: *"We would ordinarily expect a board of directors or audit committee, as part of its oversight responsibilities for the company's financial reporting, to be reasonably knowledgeable and informed about the evaluation process and management's assessment as necessary in the circumstances."*

Additional guidance may be found in auditing literature including PCAOB Auditing Standards (AU 316) that state: *"...it is management's responsibility to design and implement programs and controls to prevent, deter and detect fraud... Management, along with those charged with governance, should set the proper tone, create and maintain a culture of honesty and high ethical standards... When management and those charged with governance fulfill those responsibilities, the opportunities to commit fraud can be reduced significantly."*³

Myth: Fraud is primarily found in large, multi-national organizations.

Truth: Fraud is not limited to companies of a certain size and composition. A finding of the 2010 study released by COSO, *"Fraudulent Financial Reporting: 1998-2007 – An Analysis of U.S. Public Companies,"*⁴ indicates that the companies charged with fraudulent reporting by the SEC, as represented within the study over a ten-year period, included startups with no assets or revenues as well as much larger companies.

Myth: It is not possible to predict potential fraud before it happens, so creating a plan in advance to deal with suspected fraud would be a waste of time and resources.

Truth: While not every instance of fraud may be predictable, companies and their audit committees are best served by gaining an understanding of fraud risk factors and establishing a plan in advance to deal with suspected fraud expeditiously if and when it arises rather than scrambling to identify and pull together adequate resources in the midst of a crisis.

¹ Refer to the appendix of this practice aid for a listing of several recommended anti-fraud program resources

² Refer to SEC interpretative release *Commission Guidance Regarding Management's Reporting on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934* available at: <http://www.sec.gov/rules/interp/2007/33-8810.pdf>

³ Refer to paragraphs .01-.12 of the AICPA's Statement on Auditing Standards No. 99, *"Consideration of Fraud in a Financial Statement Audit,"* which is included in the PCAOB's interim standards (AU 316) available at: <http://pcaobus.org/Standards/Auditing/Pages/AU316.aspx>

⁴ Refer to the Committee of Sponsoring Organizations of the Treadway Commission's (COSO) 2010 study *"Fraudulent Financial Reporting: 1998-2007 – An Analysis of U.S. Public Companies"* available at: <http://www.coso.org/documents/COSOFRAUDSTUDY2010.pdf>

► STRENGTHENING CORPORATE GOVERNANCE continued

CREATING AN ANTI-FRAUD ENVIRONMENT

Building an anti-fraud environment can serve to significantly reduce the risk of fraud and increase the likelihood that, if fraud does occur, it will be detected at an early stage.

Step 1: Understanding the **fraud risk factors** an organization faces. This requires an on-going assessment of risks along with the controls that a company has in place to mitigate those risks on an enterprise-wide basis. The activities associated with building a company's fraud **risk profile** include:

- identifying *susceptibility* of the organization to various types of fraud (e.g., asset misappropriation, financial reporting fraud and corruption) and *who* is likely to commit fraud (e.g., internal - management, employees; external);
- understanding industry "red flags;"
- determining *likelihood and significance* of potential frauds; and
- assessing *effectiveness* of anti-fraud controls in place.

Step 2: Setting the **tone at the top** with regard to the effectiveness and visibility of board and audit committee oversight. The activities associated with oversight include:

- understanding *what the most significant fraud risks are* and where the organization may be susceptible to *pressure, opportunity and rationalization* to commit fraud ("warning signs")
- reviewing significant relevant transactions, asking difficult and probing questions, and developing alternative sources of information about what is happening in the company with respect to fraud risks
- evaluating the programs and controls that management has developed for managing fraud risks
- cultivating an ethical corporate culture by ensuring a comprehensive and accessible Code of Conduct is developed and actively supported by management and the audit committee
- *independently* assessing and monitoring effectiveness of the anti-fraud environment on a periodic basis.

Step 3: Evaluating the **organizational structure in relation to existing anti-fraud policies and procedures**. The activities associated with this step rely on consideration of the:

- *susceptibility* of the organization structure to fraud – e.g., opportunity for management override of internal controls; locations where cultural differences may overtly or inadvertently lead to the occurrence of fraud
- *effectiveness of policies and procedures* designed to prevent/detect fraud – e.g., performing background investigations of newly hired employees and existing employees on a periodic basis, establishing whistle-blower hotlines, disclosure to regulatory and law enforcement authorities, and developing controls over information security and records retention
- development of *protocols and procedures* in advance to handle suspected fraud if and when it does occur.

See **CAQ Guidance** section for the Center for Audit Quality's (CAQ's) 10 question guide for audit committees in exercising *skepticism* when inquiring about financial reporting fraud.

►STRENGTHENING CORPORATE GOVERNANCE continued

EFFECTIVE MECHANISMS FOR REPORTING, INVESTIGATING AND REMEDIATING FRAUD

Even when there is effective oversight and the risk of fraud within an organization is significantly reduced as a result, there is always the possibility that fraud will still occur. So, what does the audit committee need to do now to detect fraud at an early stage and be able to remediate the system of internal control and minimize damage?

As required under the Sarbanes-Oxley Act of 2002, public entities are required to maintain effective **whistleblower hotlines** to handle employees' allegations of financial reporting fraud. In addition to these hotlines, allegations of fraud can be identified through many other sources including external and internal auditors, consultants, customers, vendors, anonymous tips, the SEC⁵ and others. Regardless of the source, audit committees should demand immediate access to information supporting allegations of significant fraud occurring within the organization and give such matters the highest priority.

Once suspected fraud comes to the attention of the audit committee, it should evaluate the need to conduct an independent investigation⁶ into the alleged fraud. Fiduciary responsibility is first and foremost! The focus of independent investigations involves the following protocols and scoping considerations and often needs to be a flexible and an iterative process. The audit committee may fulfill its responsibility by engaging investigative counsel and forensic accountants, as appropriate⁷:

- identify who should be involved, both within and external to the company
- define specific roles and responsibilities of individuals
- perform an initial assessment to gather evidence and determine the potential scope/magnitude of the fraud
- identify individuals to interview and conduct thorough interviews
- determine additional procedures required (e.g., computer-assisted data analysis techniques, customer calls/confirmations, etc.)
- ensure regulatory or statutory requirements are appropriately met
- evaluate results and remediate
- determine whether disciplinary actions are appropriate or criminal charges should be brought
- ensure proper disclosures are made
- document findings (how the matter arose; who was involved; who was interviewed; what other evidence was discovered; how the matter was handled; results and why certain conclusions were reached and how they were communicated)
- based upon above, take preventive measures for the future, including making enhancements to internal controls

Regardless of whether an investigation is conducted in-house or is outsourced to an independent third party, the audit committee must be involved in every step of the process and must have a plan in place *in advance* to "triage" instances of suspected fraud to ensure that it is handled properly and handled by the right individuals. Along these lines, a best practice is to cultivate relationships with external advisors *before their services may be needed*. Audit committees need to be prepared to spend time and effort throughout the process, as these investigations often take on a life of their own. At the end of this experience, ensure that there is proper reflection on what went wrong and that adjustments are made to policies, procedures and controls and that education is provided throughout the organization to help prevent future recurrence.

For further guidance on conducting investigations, refer to the BDO Consulting's "Investigative Tips for the Non-Investigator" publication available at: <http://www.bdoconsulting.com/resources/thought-leaders/investigative%20tips.pdf>

SUMMARY

Facing allegations of fraud within an organization can be a frustrating and challenging time for those charged with governance. Cultivating an ethical culture and having established policies/procedures and identified resources in advance of fraud allegations will allow those with oversight responsibility the wherewithal to react quickly and effectively to combat fraud and minimize the damage to the organization.

⁵ The SEC may issue a letter known as a **Wells Notice** to individuals or companies when it is planning to bring an enforcement action against them. The Wells Notice indicates that the SEC staff has determined it may bring a civil action against an individual or company, and provides the opportunity to the individual or company to provide information as to why the enforcement action should not be brought.

⁶ Refer to the **Ac'sense**SM November 2010 Internal Investigation program for further insight into conducting an effective and efficient internal investigation at: <http://www.bdo.com/acsense/events/InternalInvestigations.aspx>.

⁷ Note: Many of the protocols outlined can and should be established *before* fraud occurs and should be considered as part of the audit committee's creation of an anti-fraud environment.

►STRENGTHENING CORPORATE GOVERNANCE continued**CAQ GUIDANCE: INQUIRING ABOUT FINANCIAL REPORTING FRAUD – A GUIDE FOR AUDIT COMMITTEES⁸**

The following is a list of questions prepared as a guide for audit committees excerpted from the Center for Audit Quality's (CAQ's) 2010 report, "Deterring and Detecting Financial Reporting Fraud – A Platform for Action." The questions were prepared by the CAQ as a starting point in order to "advance the thinking of audit committees around the most likely sources of weakness, with a particular eye for business pressures that may influence accounting judgments or decisions." Audit committees should customize these questions further to apply to their organizations:

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 concern 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 non-financial 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?

⁸ Refer to the CAQ's report on "Deterring and Detecting Financial Reporting Fraud – A Call to Action" available at: <http://www.thecaq.org/Anti-FraudInitiative/CAQAnti-FraudReport.pdf>.

► STRENGTHENING CORPORATE GOVERNANCE continued

RECOMMENDED ANTI-FRAUD PROGRAM RESOURCES⁹:

- BDO Consulting's Fraud Prevention Program includes the following elements designed to assist management and audit committees in the prevention, detection and remediation of fraud:
 - Fraud risk assessment
 - Fraud education
 - Ethics awareness and education
 - Background investigations
 - Mechanisms for reporting and investigating fraud
 - Board and audit committee oversight

For further information on how BDO Consulting can assist your company in forming an effective anti-fraud program, please visit: <http://www.bdoconsulting.com/services/fraud-prevention-consulting.aspx>

- BDO's **Ac'sense**SM program includes several CPE-worthy webinars/self-study courses on the topics of ethics (e.g., *Ethics and the Corporate Board*) and fraud within the *Focus on Fraud Series*:
 - Internal Investigations (2010)
 - Focus on Fraud: Lessons Learned (2010)
 - Focus on Fraud: Fraud and Misconduct in the Corporate World (2009)
 - Focus on Fraud: The Series Continues (2009)

For further information and access to archived courses, visit: <http://www.bdo.com./acsense/archive.aspx>

The CAQ's anti-fraud initiative site is available at: <http://www.thecaq.org/Anti-FraudInitiative/index.htm>. As part of this initiative, consider the CAQ's 2010 report "*Deterring and Detecting Financial Reporting Fraud – A Platform for Action*," which focuses on financial reporting fraud at publicly-traded companies of all sizes and is available at: <http://www.thecaq.org/Anti-FraudInitiative/CAQAnti-FraudReport.pdf>.

Association of Certified Fraud Examiners' (ACFE) Fraud Resources available at: <http://www.acfe.com/resources/resources.asp>

The AICPA **Anti-Fraud and Corporate Responsibility Center** provides various tools and information to professionals in combating fraud available within: <http://www.aicpa.org>

AICPA Fraud and Forensics publications – while aimed at CPAs, these resources may provide additional guidance useful to management and audit committees and are available at: <http://www.aicpa.org/Publications/Fraud/Pages/Fraud.aspx>

⁹ At the time of release of this practice aid, the PCAOB has announced that it is in the process of establishing the Financial Reporting Fraud Resource Center to facilitate the prevention and detection of financial reporting fraud. Its primary objectives will be to maintain and develop information related to financial reporting fraud, which can arise from a broad array of factors, including accounting and disclosure, auditing, corporate governance, insider trading, executive compensation, economic and other environmental circumstances, among other things. The Center will publish public reports on risks, and assist in developing educational materials, related to financial reporting fraud.

▶ ENDNOTES

1. Note: In June 2010, the U.S. Supreme Court issued a ruling that gives the SEC broader power to remove PCAOB members "at will" (rather than just "for cause") while upholding the constitutionality of the establishment of the PCAOB itself, allowing the PCAOB to continue without interruption to carry out its mission of oversight of public company audits.
2. Refer to COSO "Fraudulent Financial Reporting: 1998-2007 – An Analysis of U.S. Public Companies" at: <http://www.coso.org/documents/COSOFRAUDSTUDY2010.pdf>.
3. Source: Executive summary of the COSO framework, which may be accessed within the COSO website at: <http://www.coso.org/guidance.htm>.
4. Refer to AICPA's Audit Committee Toolkit Private Companies available for purchase at: <http://www.aicpa.org/Pages/Default.aspx>
5. Source: Renaissance Capital IPO Home website as September 28, 2010 – <http://www.renaissancecapital.com/IPOHome/Press/IPOPrings.aspx>
6. Refer to a September 2010 article "A Closer Look at the IPO Pipeline: What Lies Ahead" posted by Renaissance Capital available at: <http://www.renaissancecapital.com/IPOHome/Review/2010Pipeline.pdf>
7. Refer to an article highlighting the Thomson Reuters/Freeman Consulting poll released in November 2010 available at: <http://www.reuters.com/article/idUUSTRE6AE1F220101115>
8. Smaller reporting companies, as currently defined in SEC Regulation S-K, who are listed in the American Stock Exchange (NYSE AMEX) are required to have an audit committee of at least two members, comprised of solely independent directors.
9. The NACD publication contains very useful summaries and appendices and is available for purchase on the NACD website at: <http://www.nacdonline.org/>.
10. Along with the interpretative guidance with respect to disclosure of liquidity and capital resources, the SEC issued in September 2010 a proposed rule requiring enhanced disclosures regarding short-term borrowings within MD&A. The proposing and interpretive releases are available at: <http://www.sec.gov/rules/proposed/2010/33-9143.pdf> and <http://www.sec.gov/rules/interp/2010/33-9144.pdf>
11. The Center for Audit Quality (CAQ) was established by members of the public company auditing profession along with the AICPA to create a public policy and information forum to help serve investors, public company auditors and the markets. The CAQ's mission is to make the audit process more reliable and useful for investors in the face of growing financial complexity and market globalization.
12. Refer to Center for Audit Quality "Report on the Survey of Audit Committee Members" (March 2008) available at: <http://www.thecaq.com/resources/caqresearch.htm>.
13. Refer to the NACD's Directors Registry accessible via: <http://www.nacdonline.org/>.
14. Readers may refer to BDO's Shareholder Questions publication for further insight into key questions to consider with regard to audit committees and their responsibilities at: <http://www.bdo.com/publications/assurance/>.
15. The AICPA's Audit Committee Effectiveness website has numerous resources available for purchase, including its Audit Committee Toolkits for public companies and, for private companies, respectively.
16. Readers may refer to BDO's Financial Reporting Letter – March 2003, *SEC Meets Sarbanes-Oxley Rulemaking Deadline*, for a summary of preapproval along with other significant requirements at: http://www.bdo.com/publications/assurance/finrptnl/fr_mar_2403/.
17. Refer to the SEC's final rule 33-8183, Strengthening the Commission's Requirements Regarding Auditor Independence at: <http://www.sec.gov/rules/final/33-8183.htm>.
18. Refer to the December 11, 2006 speech delivered by Michael Husich of the Office of the Chief Accountant of the SEC at: <http://www.sec.gov/news/speech/2006/spch121106mwh.htm>.
19. The "Report of the NACD Blue Ribbon Commission on The Audit Committee" is referred to throughout this publication and may be purchased on the NACD's website at: www.nacdonline.org/.
20. The PCAOB has issued and the SEC has approved ethics and independence rule, Rule 3526, *Communication with Audit Committees Concerning Independence*, that supersedes the PCAOB's interim independence requirements, Independence Standards Board No. 1, *Independence Discussion with Audit Committees ("ISB No. 1")* and two related interpretations.
21. PCAOB Interim Standards along with PCAOB AS 5 are available at: www.pcaob.org.
22. Note: AICPA SAS 114, *The Auditor's Communication with Those Charged with Governance*, extends communication guidance contained in SAS 61 to those charged with governance of nonpublic companies while AICPA SAS 115, *Communicating Internal Control Related Matters Identified in an Audit*, requires the auditor to communicate in writing to those charged with governance of nonpublic companies significant deficiencies and material weaknesses identified during the financial statement audit similar to requirements in AS 5 for integrated audits of public companies. Both SAS 115 and 114 are available at: www.aicpa.org.
23. Excerpted from the PCAOB September 2010 Roundtable Communications with Audit Committees briefing document available at: http://pcaobus.org/Rules/Rulemaking/Docket030/Briefing_Paper.pdf.
24. Refer to Section 406 of the Sarbanes Oxley Act of 2002 – Code of Ethics for Senior Financial Officers.
25. This publication may be downloaded from the AICPA's website at: http://www.aicpa.org/ForThePublic/AuditCommitteeEffectiveness/DownloadableDocuments/achilles_heel.pdf.
26. Excerpted from "Roundtable: The 2010 Audit Committee Agenda – Uncertainty Rules" included within the NACD Directorship April/May 2010 publication. This article summarizes chief concerns of audit committees as discussed at the 2010 annual Audit Committee Issues Conference sponsored by the NACD, KPMG's Audit Committee Institute, Weil Gotshal & Manges and the University of Miami. Refer to the NACD website for further information at: <http://www.nacdonline.org/>.
27. Refer to paragraphs .01-.12 of Statement on Auditing Standards No. 99, "Consideration of Fraud in a Financial Statement Audit," which is included in the PCAOB's interim standards (AU 316) available at: <http://pcaobus.org/Standards/Auditing/Pages/AU316.aspx>.

▶ ENDNOTES CONTINUED

28. Refer to "The Fraud Diamond: Considering the Four Elements of Fraud," an article by David Wolfe and Dana Hermanson published in the CPA Journal (December 2004) and available at: <http://www.nysscpa.org/cpajournal/2004/1204/essentials/p38.htm>.
29. Refer to COSO "Fraudulent Financial Reporting: 1998-2007 – An Analysis of U.S. Public Companies" at: <http://www.coso.org/documents/COSOFRAUDSTUDY2010.pdf>.
30. Refer to the CAQ's "Deterring and Detecting Financial Reporting Fraud – A Platform for Action" available at: <http://www.thecaq.org/Anti-FraudInitiative/CAQAnti-FraudReport.pdf>.
31. Refer to page 22 of the CAQ's "Deterring and Detecting Financial Reporting Fraud – A Platform for Action" available at: <http://www.thecaq.org/Anti-FraudInitiative/CAQAnti-FraudReport.pdf>.
32. For further information on BDO's Fraud Prevention Program or BDO's Investigations & Compliance and Risk Advisory Practices visit: <http://www.bdoconsulting.com/services/consultingservices.aspx>.
33. Refer to further guidance contained within the AICPA's "Management Override of Internal Controls: The Achilles Heel of Fraud Prevention" available at: http://www.aicpa.org/ForThePublic/AuditCommitteeEffectiveness/DownloadableDocuments/achilles_heel.pdf.
34. Refer to the FCPA Enforcement document "The FCPA Explained" available at: <http://www.fcpaenforcement.com/explained/explained.asp>.
35. Refer to Compliance Week article by Melissa Klein Aguilar issued July 13, 2010, "Audit Committee Checklist: FCPA Compliance" at: <http://www.complianceweek.com/>.
36. For further information on BDO's Investigations & Compliance and Risk Advisory Practices visit: <http://www.bdoconsulting.com/services/consultingservices.aspx>.
37. Note: For those companies currently subject to audits of internal control over financial reporting, findings and recommendations made by the auditor may be communicated in conjunction with discussion of the audit of ICFR.
38. Refer to AICPA's Audit Committee Toolkit Private Companies available for purchase at: <http://www.aicpa.org/Pages/Default.aspx>.
39. Refer to footnote 22 within the SEC Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934 available at: <http://www.sec.gov/rules/interp/2007/33-8810.pdf>.
40. Refer to ¶179 of PCAOB AS 5 available at: <http://pcaobus.org/Pages/default.aspx>.
41. Source: Executive summary of the COSO framework, which may be accessed within the COSO website at: <http://www.coso.org/guidance.htm>.
42. Note: AICPA SAS 115, as it pertains to nonpublic companies, aligns the definitions of significant deficiencies and material weaknesses with those included in PCAOB AS 5. SAS 115 also requires the auditor to communicate in writing to the audit committee or those charged with governance of nonpublic companies SDs and MWs identified during the course of the audit. Refer to the earlier section on required communications. SAS 115 is effective for audits of financial statements for periods ending on or after December 15, 2009, with earlier implementation permitted.
43. Refer to BDO's *Attitudes to IFRS v2.0* available at: <http://www.bdo.com/ifrs/>.
44. Refer to *BDO Knows: Federal Tax September 2010*, which summarizes two IFRS announcements (2010-75 and 2010-76) regarding implementation guidance for the IRS' Schedule UTP 9Uncertain Tax Position) at: <http://www.bdo.com/download/1463>.
45. Refer to NACD Directorship article in the December 2010/January 2011 edition entitled: "In Practice – Listen Closely: Is that a Whistle Blowing Or a Slot Machine Ringing?" by Anthony Lendez and Nicole Sliger of BDO Consulting.
46. The "Report of the NACD Blue Ribbon Commission on The Audit Committee" is referred to throughout this publication and may be purchased on the NACD's website at: www.nacdonline.org/.
47. Refer to the SEC's final rule 33-8220, Standards Relating to Listed Company Audit Committees – Section II. Discussion – E. Funding at: <http://www.sec.gov/rules/final/33-8220.htm>.
48. Management letters, when and if issued, typically include recommendations for improvement provided by the auditor to management based upon observations made during the course of the audit. See earlier discussion.
49. The AICPA's Audit Committee Effectiveness website has numerous resources available for purchase, including its Audit Committee Toolkits for public companies and, for private companies, respectively.
50. The AICPA's Audit Committee Effectiveness website has numerous resources available for purchase, including its Audit Committee Toolkits for public companies and, for private companies, respectively.
51. Excerpted from the *Report of the New York Stock Exchange Commission on Corporate Governance* issued September 23, 2010 accessible via: <http://www.nyse.com/pdfs/CCGReport.pdf>.
52. Note: The NYSE requires audit committees to perform an annual self-assessment under 303A.07(c)(ii) of the *NYSE Listed Company Manual* available at: <http://www.nyse.com/regulation/listed/1182508124422.html>.
53. The AICPA's Audit Committee Effectiveness website has numerous resources available for purchase, including its Audit Committee Toolkits for public companies and, for private companies, respectively.



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