

Navigating the Auditor-Audit Committee Relationship

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Today's Agenda

1. Oversight of financial reporting and internal controls
2. Fraud, corruption and noncompliance responsibilities
3. Key matters to discuss with your auditors

90% of the battle is knowing what questions to ask!



PART 1

Oversight of Financial Reporting and Internal Controls



Internal Controls

- Processes designed to achieve organizational objectives in three areas:
 - Operational effectiveness
 - Financial and nonfinancial reporting
 - Compliance with laws, regulations and policies



Types of Internal Controls

- Preventive
- Detective
- Corrective



Components of Internal Control

- Control environment
- Risk assessment
- Information and communication
- Control activities
- Monitoring of controls



Auditor Responsibilities

- Issue an opinion on whether the financial statements are fairly presented in all material respects
- Applies to the basic statements and all notes
 - Are the financial statements accurate?
 - Are they complete?
 - Do they conform to GAAP (or IFRS)



Auditor Responsibilities – Public Companies

- An additional report attesting to the accuracy of management's report on internal controls (SOX section 404)
 - Whether management has identified any material weaknesses in internal controls over financial reporting



Auditor Responsibilities – Grant Funded Organizations

- A report on compliance with laws and regulations applicable to certain federally-funded programs (i.e. “major” programs)
 - Including identification of weaknesses in internal controls over compliance



Internal Control Responsibilities

Management

- Establish internal controls designed to achieve all three objectives
- Monitor internal controls
- Identify, report and remediate deficiencies
- Communicate deficiencies with auditors

Auditor

- Gain understanding of internal control over financial reporting
- Risk assessment – impact on financial statements
- Limited testing of internal controls (404, government audits)
- Report significant deficiencies and material weaknesses to A.C.



Key Auditor Steps Relating to I.C.

- Conduct a risk assessment
 - How could FS be materially misstated as a result of error or fraud
- ➔ • Discuss with audit committee
- Gain an understanding of internal controls
 - Only IC over financial reporting
- Based on the understanding of internal controls, and other information gathered, design audit procedures to achieve the audit objectives
- No requirement to test internal controls, unless 404
- ➔ • Communicate planned audit scope and key procedures to audit committee before audit commences
- Communicate significant deficiencies and material weaknesses in internal controls at end of audit



PART 2

Fraud, Corruption and Noncompliance Responsibilities



Compliance Risks

- Auditor responsibilities involving compliance risks are driven primarily by two factors
 - Fraud
 - Illegal acts



Management's Responsibilities

- Part of the “new” (2013) COSO internal control framework considered by auditors requires that management perform a fraud risk assessment
- Audit committee:
 - Inquire of management about and discuss this fraud risk assessment
 - How was it performed?
 - What were the most material inherent fraud risks identified?
 - Were any fraud risks identified with higher than acceptable residual risks?
 - If so, what remediation actions are being taken?



Auditor's Fraud Risk Assessment

- Material misstatements in the FS caused by one of two factors
 - Error
 - Fraud
- Types of fraud considered by auditors
 - Asset misappropriation – theft by employees, other insiders
 - Financial reporting/accounting fraud
- One type of fraud not considered by auditors:
 - Bribery and corruption - why?
 - Not a direct effect on the financial statements (unless asset misappropriation is also involved or certain other illegal acts involved – more on this later)



Ask the Auditor

- How did they perform their fraud risk assessment (i.e. what information they considered, who they spoke with, etc)?
- What were the results of the fraud risk assessment?
- What audit procedures they performed in response to their fraud risk assessment?



Illegal Acts

- Defined as violations of laws or government regulations
- Auditor must consider laws and regulations that have a direct and material effect on the financial statements
 - Responsibility is same as that for errors or fraud – design appropriate audit procedures based on risk assessment
- Examples of direct effect on financial statements:
 - Income taxes, Internal Revenue Code
 - Revenue-related laws, such as False Claims Act
- Laws with an indirect effect on FS include those in which a violation could result in a fine or penalty (e.g. FCPA, environmental, FLSA, etc)
 - The majority of compliance considerations



Detection of Illegal Acts

- No requirement to design audit procedures to detect violations of laws with indirect effect on financial statements
- Auditor must ask AC about possible illegal acts
- If information comes to auditor's attention concerning violations of laws that could have a material indirect effect, auditor must apply audit procedures to determine whether an illegal act occurred
- How does it come to auditor's attention:
 - Audit procedures applied to laws with direct effect
 - Disclosure by client (management or audit committee)
 - Awareness of regulatory investigations, enforcement proceedings, etc
 - Other audit procedures



If Possible Illegal Acts Are Detected

- Gain an understanding of the act sufficient to assess impact on the financial statements
- Discuss with management at least one level above those involved
 - If senior management might be involved, the implication is that the auditor should discuss with the audit committee
- If management does not provide sufficient information that no illegal act occurred, consult with client's legal counsel or other specialists and perform additional audit procedures



Financial Statement Effect

- Consider quantitative and qualitative aspects of materiality
- "An illegal payment of an otherwise immaterial amount could be material if there is a reasonable possibility that it could lead to a material contingent liability or a material loss of revenue"



Other Key Audit Steps

- Auditor must make inquiries of management regarding compliance with laws and regulations
- Auditor should also obtain written representations from management concerning the absence of violations or possible violations of laws whose effects should be considered for disclosure or as a basis for recording a loss contingency



What's it Mean for You?

- Ask the auditor:
 - Which laws and regulations have they identified as having direct and possibly material effects on the FS?
 - What are their planned audit procedures in connection with those risks?
 - What were the results of their discussion with management concerning compliance with laws and regulations, and how did that discussion impact their risk assessment and design of procedures?



PART 3

Other Key Matters to Discuss with your Auditor at the Conclusion of the Audit



Illegal Acts

- What procedures they performed in connection with laws and regulations that could have a direct effect on the financial statements, and the results of those procedures?
- Did they become aware of possible violations of laws that could have an indirect effect on the financial statements and, if so, what did they do about it?
- Did they encounter any difficulties in performing their audit procedures relating to illegal acts (or fraud)?
- Did they have any disagreements with management in connection with assessing whether illegal acts occurred?



Fraud

- What were the results of the procedures they performed in response to their fraud risk assessment?
- Did they need to modify any of their audit procedures as a result of new information that came to their attention during the audit?
 - Note – the auditor’s fraud risk assessment is expected to continue through to the end of the audit; It is not merely a planning step done before the audit commences.
- Did they discover any possible frauds?
- Did they identify any red flags of fraud that they looked into?



Internal Control Deficiencies

Material Weakness

Significant Deficiency

Control Deficiency



Material Weakness in I.C.

- 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



Let's Analyze That a Bit...

- 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



Significant Deficiency in I.C.

- 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



For Discussion

1. How/why did you determine that this particular weakness in internal control was material?
 - And, explain the corrective action
2. What deficiencies in internal controls did you identify during the audit that did not rise to the level of materiality that required reporting them to us?
 - Only material weaknesses and significant deficiencies are required to be reported
3. What else did you observe about our operations that could be improved or that we could benefit from discussing?



Conclusions

- The auditor's primary role is to express an opinion on the financial statements
- Very little of their work is focused on compliance matters
- However, they do have specific areas of focus that are quite relevant to compliance, beyond compliance with GAAP
- There are numerous auditor communications responsibilities beyond those covered here
- The key is to understand the auditor's compliance-related responsibilities and to know what questions to ask and discussions to have with the auditors



QUESTIONS ??

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