The need to address current and emerging issues is a fundamental requirement for effective management because the issues can have a direct or indirect effect on a company’s control environment, financial reporting, and the audit process. Understanding how the company responds to the challenge is fundamental to an audit committee in discharging its responsibilities. An audit committee must be mindful of what is happening within a company now and, at the same time, what may happen in the future. In today’s global economy and formidable business environment, being prepared is a major ingredient for success.

### Questions to identify current and emerging issues shaping the audit committee agenda

- Is the board of directors adequately overseeing management’s process for identifying and monitoring principal business risks? What risks are acceptable to the company, and through what process are they being managed? Is ERM being used to manage an organization’s key business risks and opportunities with the intent of maximizing shareholder value?
- Is the audit committee contributing to a “no surprises” environment? Is the audit committee alert to the indicators contributing to the company’s risk profile?
- Does management report operations in a clear and responsible way? Could the company satisfactorily respond to a securities regulator enquiry into earnings management?
- Is the audit committee alert to factors increasing the risk of fraud and illegal acts? Does the audit committee understand how to minimize the risk of loss arising from fraud?
- Have management and the audit committee remained abreast of recent developments in financial reporting and recent regulatory actions? Have the complexities of new financial reporting requirements and, in particular, issues arising on conversion to International Financial Reporting Standards (IFRS), been fully understood and evaluated in the context of the company’s business and business transactions?
- Do the processes and controls adequately support the organization’s complexity and international reach?
- Are controls and systems keeping pace with the company’s growth?
• Have the control implications for enterprise-wide solutions been adequately addressed? Have controls been enhanced through the introduction of new systems?
• Are any dominant executives adequately governed?
• Does the audit committee tailor its responsibilities to reflect specific industry considerations?
• Has management addressed specific industry regulations and requirements?
• Are members of the audit committee fulfilling their responsibilities as directors and thereby mitigating potential liability?

**Current trends**

**Earnings management**

Are management reporting operations conducted in a clear and responsible way? Could the company satisfactorily respond to a regulator’s enquiry into earnings management?

Recent high-profile irregularities reported in the press have been attributed to various earnings management practices. These include questionable revenue recognition; inappropriate deferral of expenses; and recognition, reversal, or use of reserves without events or circumstances to justify such actions.

These practices have come to the attention of securities regulators and others in companies’ accounting policies and procedures, and have led to questions about the quality of reported earnings.

Information is the lifeblood of the capital markets. If a company fails to provide meaningful disclosure to investors about where it has been, where it is and where it is going, a damaging pattern ensues. The bond between shareholders and the company is shaken; investors grow anxious; prices fluctuate; and the trust that is the bedrock of capital markets is severely tested.

Earnings management is a problem that, perhaps, is more widespread than we might think. Everyone, in whatever field, who has information to impart wishes to manage the way in which the information is communicated and the particular message or ‘spin’ that it, is to be given. Management is not immune from this temptation, and earnings management is one of the ways in which this is done.

It is important that audit committees recognize the circumstances from where the pressure arises. It could be that:

• market expectations are unrealistic; or
• targets are not being met; or
• management is too heavily incentivised.

The pressure to achieve earnings targets can place a heavy burden on senior management, in terms of both job security and remuneration. Unfortunately, this pressure can all too often lead to the consideration of aggressive and sometimes incorrect financial reporting interpretations.

Audit committees need to know enough about their company to recognize when these conditions are present and, in that case, they need to receive what they hear with some skepticism. If audit committees do not do this, many of the improvements in the quality and reliability of financial reporting in recent years will be undermined just when they are most needed.

Auditors also must play their part. No auditor should be unaware of the problem. The traditional audit qualities of rigor and skepticism will be needed, but they may not be enough. Even if the auditor recognizes what is going on, there may
be little that can be done about it, if it falls within certain bounds. The auditor’s role is to express an opinion on the truth and fairness of the accounts, and these are usually tested by reference to accounting standards and other requirements having regard to materiality.

Accounting standards do not, however, produce financial statements that are ‘right’ in the sense that there is only one possible answer. Their application can sometimes produce a range of possible answers. For example, valuations and estimates, which inevitably require judgement, are needed in relation to many elements of the financial statements - particularly in relation to transactions that span the year-end or several years.

The benefit of this inherent flexibility is that it allows accounting to keep pace with business innovations.

The downside is that abuses such as earnings management can occur when people exploit this pliancy. This is why the highest standards of objectivity, integrity and judgment must be the rule, not the exception.

How should audit committee members respond? Audit committee members must fulfill their fiduciary responsibility; they should understand the company; they should be briefed and stay up to date; they should ask searching questions and be active participants in the oversight function.

Specific areas of accounting standards that may obscure financial volatility and adversely affect the quality of reported earnings are:

- **Revenue recognition** - Recognising turnover before a sale is complete, or at a time when the customer still has options to terminate, void or delay the sale - has assumed great importance in recent years. This is particularly so for “new economy” companies where the focus is often on revenue rather than profit.

- **Changing estimates** - Changing estimates to make the numbers is another frequently used method for managing earnings. While this may be perfectly acceptable when supported by real economic facts, all too often estimates are altered when the underlying economics of the business do not support the change, and without any disclosure to investors. As such, investors end up using numbers for investment decisions that lack transparency, consistency and comparability.

- **Abuse of the materiality concept** - The intentional recording of errors (or a failure to correct errors) on the grounds that their impact on the bottom line is not significant; however, given the market’s reaction to small changes in earnings per share, what is significant and what is not?

- **Capitalisation and deferral of expenses** - Capitalising and deferring costs that should be accounted for as a cost of the period through, for example, ambiguously defined capitalisation criteria for property, plant and equipment and intangible assets, unreasonable amortization periods, or through the capitalisation of costs for which future economic benefits are not reasonably assured.

- **Non-GAAP measures** - This is a device that some companies can use to disseminate an idealized version of their performance that excludes any number of costs and expenses yet still suggests reliability and comparability. Often undue emphasis is placed on results before exceptional items, or start up operations, or earnings before interest, tax and depreciation (EBITDA), and even marketing expenses as if some costs were somehow capable of being ignored. This may be perfectly appropriate, and consistent with what is done in the industry, but the impression given can be of a lack of balance. Regulators are becoming more concerned about such practices.
Fraud and illegal acts

Is the audit committee alert to factors increasing the risk of fraud and illegal acts? Does the audit committee understand how to minimize the risk of loss arising from fraud?

The nature of fraud risk is expanding. The globalization of business means that management may find it is doing business with people it doesn’t know in countries it has never visited, employing cultural standards it doesn’t understand. As well, technological advances have changed the speed and ways business transactions are recorded; these advances have enhanced opportunities for fraud and have greatly increased the potential quantum of losses arising from fraud.

How can the audit committee ensure that appropriate procedures are in place to minimize the risk of losses arising from fraud?

Unpalatable though it may be, the audit committee has to address the risk of fraud head-on. The identification of the risk of losses arising from fraud through diagnostic studies of the risk of fraud and misconduct in the business should be considered an important first step. The audit committee should question whether management has considered those risks likely to have greatest financial, reputation or regulatory impact on the business. The assessment should include identifying fraud risks and a rigorous assessment of any relevant internal controls and their ability to prevent and/or detect fraud.

The audit committee should determine whether a consistent approach is taken across the business, whether those risks assessed as high are dealt with appropriately and whether management is engaged in the process. It is important that staff at all levels receive some training in fraud awareness relevant to their business sector.

A common theme arising from the investigation of many frauds is the fact that countless people in the affected organization knew or suspected that irregularities were occurring, but were not given the skills to identify the signs of fraud or provided with an opportunity to communicate their concerns. The audit committee should enquire as to whether the company has an effective awareness programme, which is updated as appropriate and is provided in a relevant format to different levels of management and staff (including new joiners).

The audit committee is not involved in day-to-day management, and therefore is not closely involved with the detail on matters related to fraud and unethical activities. However, it can usefully focus attention on the need for proper policies and procedures to help prevent fraud and unethical activities. The audit committee should question whether appropriate policies have been established and whether they are user friendly and adopted by all relevant business units. Policies that might be considered include a fraud response plan and a whistle blowing policy. The committee should consider not just whether these are appropriate, but whether they are effective and how the business units have confirmed this. The audit committee’s objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action - therefore an oversight role.

The committee should ensure management is providing clear direction to the business on fraud and are requesting and receiving relevant information on suspected fraud and risks.
The following are, among other factors, sometimes seen as symptomatic of a potential for fraud to occur:

- An overly dominant CEO with unfettered powers.
- Frequent changes in finance or other directors, auditors or other professional advisers.
- Implausible explanations as to the source of profits or projections that is too good to be true.
- Individuals that have expensive lifestyles or habits that are potentially at variance with the remuneration they receive from the company.
- People that have a reputation for ‘sharp’ practices.
- Over-complicated corporate structures involving havens of secrecy.

**Whistle blowing policy**

Regulation in the US and the UK states that the audit committee should review arrangements by which employees may, in confidence, raise concerns about possible improprieties in financial reporting and other matters - in short, ensure appropriate whistle blowing policies are in place. When reviewing whistle blowing procedures, the committee should consider the following:

- Are whistle blowing procedures documented and communicated throughout the organization?
- Does the policy make clear that it is both safe and acceptable for employees to raise concerns about wrongdoing?
- Are whistle blowing procedures arrived at through a consultative process? Do employees buy-in to the process?
- Are concerns raised by employees responded to within a reasonable time frame?
- Are procedures in place to ensure all reasonable steps are taken to prevent the victimization of genuine whistle blowers?
- Are there procedures to ensure all reasonable steps are taken to keep the identity of whistle blowers confidential?
- Has account been taken of confidentiality clauses in contracts of employment?
- Has a senior person to whom confidential concerns can be disclosed been identified? Does this person have the authority and determination to act if concerns are not raised with - or properly dealt with by - immediate line management?
- Are success stories publicized?
- Do managers understand how to act if a concern is raised? Do they understand that employees have the right and, indeed, the duty to blow the whistle?
- Has consideration been given to the use of an independent advice centre as part of the whistle blowing procedure?
Enterprise package solutions

Have the control implications for enterprise-wide solutions been adequately addressed? Have controls been enhanced through the introduction of new systems?

For the past several years, enterprise resource packages (ERPs) have dominated large information technology (IT) departments and affected functional areas. Implementing ERPs - for example; SAP, Oracle, BaaN, and PeopleSoft - usually involves significant business process reengineering, technology infrastructure replacement, data conversions, interfaces to remaining legacy systems, and information security challenges at the application, database, operating system and network levels.

Certainly, ERP solutions can provide a high degree of integration that can significantly increase a company’s operational efficiency and improve the quality of information for management decision-making. But in the pressure to implement ERP the material impact of existing system operations and process controls is often overlooked. As systems are replaced, the established financial and operational controls are also replaced with the generic controls supplied by the ERP vendor. These changes raise many control issues, including:

- redesigning and co-ordinating existing processes and controls with those of the new systems;
- optimising and tailoring the controls associated with streamlined business processes;
- adequately training and transitioning employees to the new processes and systems;
- obtaining the new IT skills and processes required to administer and operate different computer platforms and networks; and
- controlling the creation, maintenance, and security of data conversion and on the new system.

The issues affect the company’s controls, its financial reporting process, and its audit process - fundamental areas of focus for the audit committee. The committee should assure itself that management has addressed these issues and that appropriate, though not excessive, controls are in place.

Complex corporate structures

Do the processes and controls adequately support the organisation’s complexity and international reach?

Are controls and systems keeping pace with the company’s growth?

Mergers, acquisitions and reorganisations often involve combining organizations not only with distinct corporate cultures but also from different industries and different areas of the world. In today’s business environment, companies frequently cross borders for every aspect of their business. This environment presents management and the audit committee with unique oversight challenges. While governance practices in such environments are slowly evolving, the influence of global business needs to be carefully considered. A number of questions may need answering:

- How are management’s reporting, control, and compliance responsibilities integrated?
- Is there effective oversight of local boards?
- How does the committee evaluate domestic and international audit results, both internal and external?
- How does management ensure compliance with various countries’ rules and regulations?
Reorganizations often mean downsizing and outsourcing. When downsizing, controls may be removed or weakened. As companies focus on core competencies, non-core activities and specialized skills are often outsourced to third-party providers. Has the organization carefully evaluated the ongoing internal control impact of such decisions? Audit committees’ responsibilities do not stop at national or organizational boundaries - they extend to the company as a whole. There needs to be coordination and communication between audit committees of parent companies and subsidiaries. There should be a common appreciation of the control frameworks and cultures of the entities, and substantial sharing of information.

**Emerging companies**

*Are any dominant entrepreneurs adequately governed?*

Fast-growing entrepreneurial companies often lack a formal management structure and may not have well established corporate governance procedures. Policies, procedures, and processes may be evolving haphazardly to meet demands. The dominant role of an individual executive also may overshadow the need to foster a strong control environment and can potentially affect the financial reporting and audit processes.

As companies grow, a more standardized corporate governance process becomes a necessity, regardless of the entity’s public aspirations. For companies considering an initial public offering, the need for a formalized structure becomes obvious. While the risks described in this publication represent important issues in today’s marketplace for public companies, they also apply to entrepreneurial and other companies that remain private. Responding to these risks is equally important to companies that wish to deter fraud and improve the quality of their financial reporting.

Dominant or autocratic management can also be a cause for concern in an established company. Such leadership can put a strain on the enterprise’s controls and corporate governance processes and set the wrong “tone at the top”. Ensuring that management fosters an atmosphere that supports a strong control environment is a core audit committee responsibility.

**Specialized and regulated industries**

*Does the audit committee tailor its responsibilities to reflect specific industry considerations?*

Has management addressed specific industry regulations and requirements? What is the relationship between the audit committee and industry regulators?

Companies may operate in one or several industries. The more diverse the company, the more attuned the audit committee should be to different industry risks, accounting practices, laws, regulations, and reporting and disclosure requirements. An audit committee must consider management’s response to the risks inherent in these specialized practices and incorporate them into its agenda. While the core responsibilities described in this toolkit are relevant to most audit committees, the manner of their execution and the specifics of audit committee activities should be tailored to meet the needs of each specific industry. An understanding of the industry and the organization will enable the audit committee member to identify and react to industry specific requirements such as those in deposit-taking institutions, health care organizations, not-for-profit organizations, investment companies, insurance companies, or governmental entities.

In considering industries that are regulated, audit committees should be acquainted with the scope of the regulation and the authority of the regulators. They should understand the demands regulators place upon the business and management’s attitude towards them and relationship with them.
Audit committee's liability

Recent judgments in the US have involved personal liability for the audit committee members failing to act.

The dominant theme to emerge from these cases is that failure of the audit committee to take action when there is evidence of weakness in the risk management, internal control or compliance systems may result in legal action against audit committee members.

These cases raise important questions such as the following for Russian audit committee members.

- To what extent might Russian courts apply these American precedents?
- Can an audit committee be held liable for acts or omissions separately from the full board?
- How can Russian audit committees protect themselves from the potential liabilities raised in these US cases?

Specific US cases

The JWP case

In this case it was found that the audit committee had not adequately consulted with the company’s internal auditors. As a result, there were continuing issues concerning the adequacy of the internal audit process.

The court held that the audit committee’s failure to act on the internal audit matter, plus the fact that it had been made aware of “dubious” accounting practices, meant the committee was willfully blind to fraud going on around it, and thus not entitled to rely on an unqualified external audit opinion.

The Anicom case

In this case shareholders claimed to have suffered losses because the audit committee ignored information from the company’s internal audit of improper practices involving widespread billing irregularities. The court upheld the shareholders’ claim. It considered that the audit committee’s failure to act on a warning of systematic fraud was an intentional or reckless breach of duty of care on the committee’s part.

The Lernout case

This case revolved around the audit committee’s failure to deal with certain matters raised by the external auditor. Although the external auditor had given an unqualified opinion, the auditor made recommendations about internal controls concerning revenue recognition, cash collections and outstanding receivables. The court considered that the audit committee had been put on notice that problems existed, but had done nothing to investigate them, nor had it received specific assurances from either the auditor or management that the problems were being resolved.

The Lernout case reinforces the proposition that, at the very minimum, the audit committee must investigate and verify for itself that problems raised by the auditor, either internal or external, have either been taken care of or are not material.

In fact, all three of these cases involve audit committee failure to respond adequately, or to respond at all, to serious concerns raised by the internal or the external auditor. In each instance, the audit committee’s failure or refusal to act represented the tip of the iceberg of a serious systematic failure within the internal control systems, resulting in considerable losses and subsequent claims against members of the audit committee.
The duty of care, skill and diligence/business judgment rule

Directors wishing to make a worthwhile contribution to their companies and shareholders will need to keep themselves well informed across a range of matters, including:

- their company’s business and the industry;
- their company’s product lines;
- risk assessment processes (i.e. the major risks faced by the company and the controls and policies put in place to manage these risks within the limits set by the board);
- the delegation of board authority to management;
- acquisitions, mergers and takeovers;
- economic and business issues (local and global) facing their company;
- committee and board evaluations;
- internal and external audit functions;
- human resources policies;
- information technology dependency and requirements;
- internal controls (including financial controls);
- long-term or scenario planning and strategy;
- specific problems affecting the business at any particular time;
- environmental and stakeholder issues (sustainability issues);
- the values, ethics and culture of the company; and
- short-term and long-term finance arrangements.

Generally, directors are expected to have at least a basic knowledge of financial reports and be capable of reading and interpreting them.

How audit committee’s can protect themselves

Principle 7 of the ASX Principles and Recommendations* require that CEOs and CFOs attest to the existence of a sound system of risk management and internal control and compliance. Although this requirement places a specific duty of care on CEOs and CFOs, it doesn’t absolve boards or their audit committees of the responsibility to monitor management, the external auditors and the internal audit function.

Principle 7 highlights the desirability of documenting risk management and internal control and compliance systems so that all participants in the assurance process clearly understand the framework in which they operate. A strong and integrated control framework also helps audit committees to discharge their responsibilities more effectively.

Management should provide sufficient information to the audit committee to allow the committee to assess the internal processes for determining and managing key risks.

Similarly, audit committees should undertake their own review of internal control systems by:

- reviewing the system management has in place for assessing internal controls (particularly those related to key areas of identified risk);
- assessing whether management has mechanisms in place to deal with unusual types of transactions that may carry more than an acceptable degree of risk;
- considering the effectiveness of and compliance with the code of conduct; and
- meeting periodically with management and compliance staff to understand and discuss the entity’s risk management and internal control environment.

* Principles of Good Corporate Governance and Best Practice Recommendations, ASX Corporate Governance Council 2003.
To clarify their own thinking on these issues, audit committees might consider the following questions:

- What constitutes "proper reliance" on statements and reports provided to an audit committee?
- What are the "red flags" that might signal problems with the internal control environment?
- How should the audit committee proceed if there is no proper internal audit function in the organization, or if the audit committee suspects that the independence of the existing internal audit function has been compromised?
- What are the signs suggesting that the internal audit function might be ineffective or compromised?
- How should the audit committee investigate further if it believes certain management statements are unreliable, even if such statements are supported by outside professional advice?
- Could any decision not to act on a matter be construed as a breach of director’s duty of care, skill and diligence?
- Has the audit committee effectively communicated its decision to the full board?
Audit Committee Institute in Russia

Boris Lvov
Corporate Governance, Performance and Compliance

Tel: +7 937 4477
E-Mail: aci@kpmg.ru

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.