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Two-Way Communication, Now That's an Idea!

Proposed Standard Turns Up the Heat for Audit Committees

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Although one-way communication is often a reality, communication is more effectively viewed as a two-way process in the exchange of information for a mutual goal. My children frequently remind me of this when I quickly pre-judge them based on my sole perspective without their input. While a two-way communication process clearly makes sense, its integration in the business world is often not effective. This includes communications between a company's board and its external auditor.

The Public Company Accounting Oversight Board (PCAOB) has set out to strengthen existing requirements for auditor communications with the audit committee through their proposed auditing standard, *Communications with Audit Committees,* issued March 29th, 2010 (PCAOB Release No. 2010-001). Now before you conclude that this is just another technical article for U.S. public companies[1], think again. This is an important topic for all organizations with a board of directors and an external auditor. After all, both parties have significant obligations to investors and stakeholders, and can be named in adverse legal actions. This indeed qualifies as a common ground for "getting-it-right" in terms of their respective duties. Hence, we have an essential ingredient for effective two-way communications. Yet there are some risks that can enter the picture as this article explores. These challenges pertain to independence, audit committee culture and transparency.

Boardroom Independence

Unequivocally, the most important duty of a board is their ability to oversee management to protect the interests of investors. The board and its committees must be unbiased in their duties to be effective. This does not mean management should be absent from the boardroom, but rather that the true decision-making power and oversight of management be held by independent directors. Yes, there are a slew of independence requirements for public companies; however, independence is a state-of-mind that cannot be adequately defined from a rules-based perspective. While directors exercise their decision-making powers by acting collectively, their judgment is exercised on an individual basis.

PCAOB's proposed auditing standard builds upon the audit committee requirements born from the Sarbanes-Oxley Act of 2002 (SOX):

- Audit committees play an important role in protecting the interests of investors.
- The audit committee assists the board of directors in fulfilling its responsibility to company shareholders and others to oversee the integrity of a company's financial statements and the financial reporting process.

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[1] Companies that have permission from the Securities and Exchange Commission (SEC) to offer its registered securities for sale to the general public

- A well-informed audit committee on accounting and disclosure matters is better able to carry out its role of overseeing the financial reporting process.

Keep in mind that for public companies without an audit committee, the entire board of directors is viewed as the audit committee. In any event, it is important for the board culture to be able to challenge management and candidly communicate with the external auditor. The same holds true for the audit firm in their ability to challenge management and engage the audit committee in their auditing process.

Auditor Independence

Perhaps drawing attention to the potential lack of auditor independence comes as a surprise for many considering the great lengths that SOX went to in addressing this, but consider the following. The proposed PCAOB standard would create a new requirement for the auditor to evaluate the adequacy of the two-way communications with the audit committee. The auditor would need to conclude if the two-way communications were adequate to support the objective of the audit. The audit objective includes the auditor's assessment of the risks of material misstatement and ability to obtain sufficient appropriate audit evidence in support of an audit opinion. The auditor is to base their evaluation on observations resulting from audit committee interactions throughout the audit process. According to the proposed standard, if the auditor determines that the two-way communications between the audit committee and the auditor have not been adequate and the situation cannot be resolved, the auditor should consider:

- Communicating with the full board of directors
- Modifying their opinion on the basis of a scope limitation
- Withdrawing from the engagement

This all sounds reasonable, but remember that it is the audit committee who hires the auditor. Therefore we have a similar concern to what we had prior to SOX when management could have a more dominant role in the hiring of the auditor. This is the inherent risk of having the auditee (i.e., the audit committee in this case) being evaluated by the one they hire. The dollars behind audit firm contracts can be quite intoxicating. It is the responsibility of both sides to have strong policies and procedures to help ensure that a cozy relationship does not develop in making each side look good at the expense of investors.

Audit Committee Culture

While the presumption has always been for audit committees to be diligent in their duties as directors, the proposed standard draws extra attention to the matter. The two-way communication evaluation goes beyond a “check-box” mentality to include auditor consideration of the:

- Appropriateness and timeliness of actions taken by the audit committee in response to matters raised by the auditor
- Openness of the audit committee in its communications with the auditor
- Willingness and capacity of the audit committee to meet with the auditor without management present
- Extent to which the audit committee probes issues raised by the auditor

Beware to the audit committee that is not taking their duties seriously as the auditor will have additional responsibilities if the proposed auditing standard is approved by the SEC. Perhaps this is the biggest change in that the standard would increase the expectation of more communication from the audit committee to the auditor. Historically, the bulk of the communication was from the auditor to the audit committee. This should serve as a final “wake-up call” for audit committees who are not adequately exploring risks or following-up on red-flags.

Transparency

The PCAOB proposal also includes requirements of:

- Communication of an overview of audit strategy, including:
    - a discussion of significant risks
    - the use of the internal audit function
    - the roles, responsibilities, and location of firms participating in the audit
- Communication regarding critical accounting policies, practices, and estimates
- Communication regarding the auditor’s evaluation of a company’s ability to continue as a going concern

Communication of significant risks identified by the auditor gives the audit committee an opportunity to understand the auditor's view of the risks of material misstatements, as well as the ability to communicate its views relating to those risks based on its knowledge of the company. This ability for the audit committee to provide their inside glimpse of the company and industry cannot be underestimated in terms of value. Keep in mind that the auditor is also probing with management, but a transparent read from the audit committee can go a long ways towards validating the business environment from a more independent standpoint. It also is an opportunity to point out risks that perhaps were previously unknown to the auditor. Success of this communication hinges on both the candor and knowledge of the individual directors, which should be considerations for nominating directors.

In conclusion, effective two-way communications throughout the audit process assists the auditor and the audit committee in understanding matters related to the audit. It helps to mitigate the risks on both sides in missing something material that warrants follow-up. Indeed, a two-way communication process is the master key for many aspects of life including business matters. If you have some thoughts on PCAOB’s proposed auditing standard, they would like to hear from you. All public comments should be received by PCAOB no later than 5:00 PM (EDT) on May 28, 2010. Here is the link. Refer to docket #030 in submitting a comment. The PCAOB anticipates that the standard would be effective, subject to approval by the SEC, for audits of fiscal years beginning after December 15, 2010.

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