

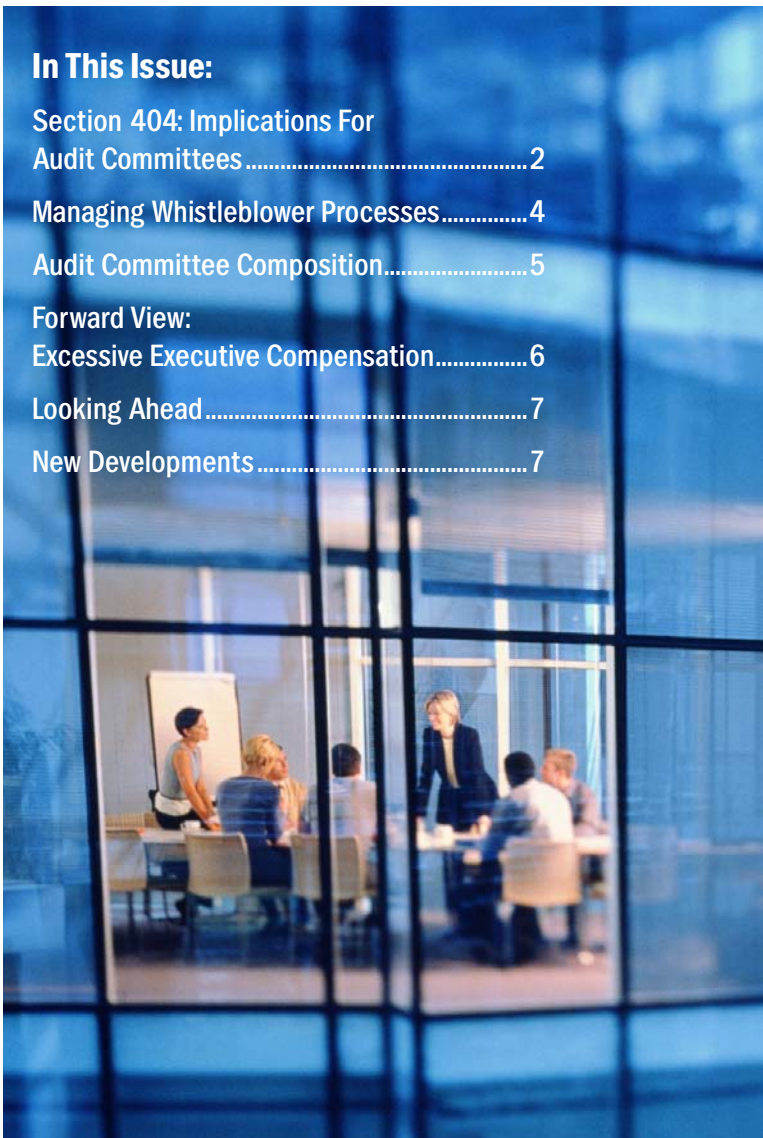
# BoardMatters Quarterly

## Critical Insights for Today's Audit Committee



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We are pleased to introduce *BoardMatters Quarterly*, a newsletter designed specifically for audit committee members. In each issue, we will share our knowledge and insights on a variety of topics, learned through our interactions with audit committee members and our work with the Audit Committee Leadership Network, a select group of audit committee chairs from America's leading companies. We will also share suggested practices you may consider as you look to adapt to this new environment and plan for the future.

Restoring the trust and confidence of investors in the capital markets is a responsibility we all share. It will require sustained high-quality, high-integrity performance by corporate management, audit committees and boards of directors, the accounting profession, investment bankers, and lawyers.

The rapidly changing regulatory landscape requires more dialogue and interaction between audit committees and the auditor. Ernst & Young's involvement extends beyond the need to communicate with you about the audit or other required work. We want to bring you relevant and timely information about the key issues and emerging trends pertinent to your role as a member of the audit committee.

Please feel free to contact us with your feedback on this first issue of *BoardMatters Quarterly*, or with your ideas for future issues. We encourage you to share this information with your colleagues and ask that you let us know of others who would benefit by receiving this publication. Send your feedback to Lisa Hallman at [lisa.hallman@ey.com](mailto:lisa.hallman@ey.com).

# Section 404: Implications for

The Section 404 internal controls reporting requirements that were created by the Sarbanes-Oxley Act have contributed to an increased focus on transparency with respect to financial reporting. Many audit committees today are reviewing financial reporting through a lens of investors and shareholders. Audit committee members also have a greater awareness of the benefits of effective internal controls, which serve to protect shareholders' long-term interests by reducing an organization's risk.

## Impact of the PCAOB's Proposed Standard

The Public Company Accounting Oversight Board (PCAOB) recently published its Proposed Auditing Standard (the Proposed Standard) relating to Section 404, which requires both management and the external auditor to report annually on internal controls over financial reporting. The Proposed Standard clearly will impact the scope of responsibilities for auditors, but it will also affect what is required of the audit committee and management.

*Audit Committees* – Audit committees today are experiencing increased responsibility and accountability for monitoring risks of the organization, including Section 404 project risks. To this end, audit committees may increase their effectiveness by closely monitoring Section 404 projects by regularly meeting and discussing project status, including target completion dates, project risks, potential control weaknesses and remediation plans, with management, internal audit, and the external auditor. In the Proposed Standard, the PCAOB emphasizes the importance of the audit committee's oversight role and requires the independent auditor to evaluate factors related to the effectiveness of the audit committee.

It may be helpful for audit committees to understand these factors under the Proposed Standard and perform a self-assessment. The PCAOB specifically states that "ineffective oversight by the audit committee of the company's external financial reporting and internal control over financial reporting should be regarded as at least a significant deficiency, and is a strong indicator that a material weakness in internal control over financial reporting exists." Under the Proposed Standard, a material weakness will require an adverse opinion on internal control by the auditor.

*Management* – The Proposed Standard specifically describes the responsibilities required of management in performing its assessment of internal controls over financial reporting, and the PCAOB emphasizes the importance of documentation to support management's assertion. Management should be aware of the documentation requirements proposed by the PCAOB, because inadequate documentation is viewed to be an internal control deficiency.

## Factors in the PCAOB's Proposed Standard Related to the Effectiveness of the Audit Committee's Oversight Responsibilities

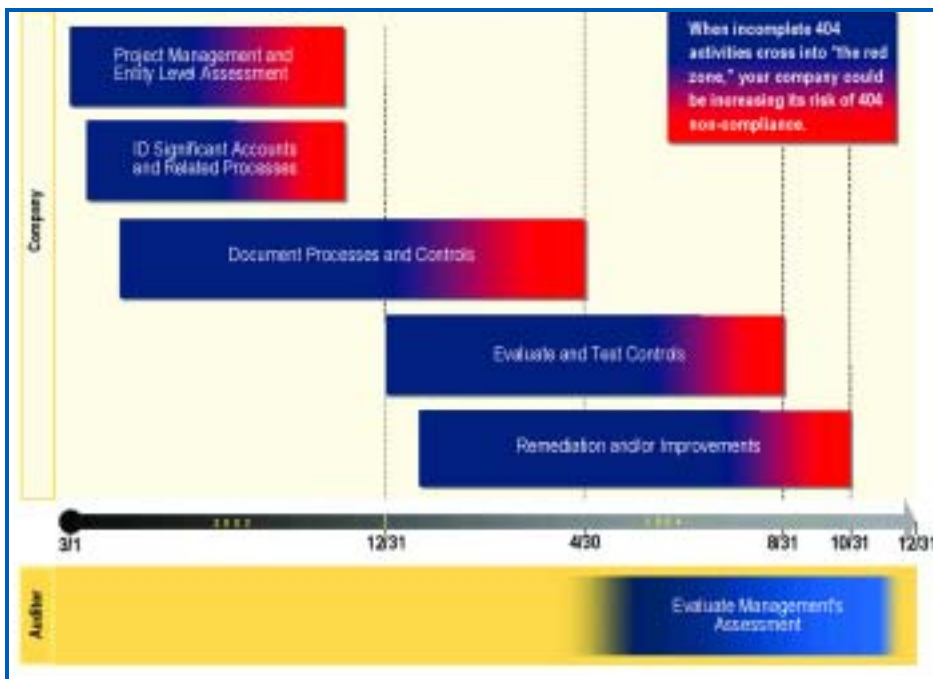
- ✓ Independence of audit committee members from management
- ✓ Clarity with which the audit committee's responsibilities are articulated, and how well the audit committee and management understand those responsibilities
- ✓ Level of involvement and interaction with the independent auditor, including the committee's role in the appointment, retention, and compensation of the independent auditor
- ✓ Level of involvement and interaction with internal audit, including the committee's line of authority and role in appointing and compensating employees in internal audit
- ✓ Committee's compliance with applicable listing standards, such as meeting separately and periodically with management, internal auditors, and independent auditors; reporting regularly to the board of directors; setting clear hiring policies for employees of independent auditors; and discussing policies with respect to risk assessment and risk management
- ✓ Whether the committee includes one or more audit committee financial experts
- ✓ Amount of time that the audit committee devotes to control issues and committee activity

Our experience shows that leading companies are viewing Section 404 as an opportunity to move beyond mere compliance and improve upon existing processes and controls. These companies are creating dedicated 404 implementation teams from their various business units, and they have a particular focus on improving the documentation of their processes. These teams are finding that, by starting to address internal controls issues early, they can more effectively minimize the possibility that internal controls deficiencies may not be detected and, by allowing time for remediation, can get an early start to improve their overall risk management framework.

*Involving the Independent Auditor* – Since the independent auditor will ultimately be required to audit management's assessment of internal controls, involving your independent audit firm early and often in the process can minimize the risk of surprises after management completes its 404 implementation project and redeploys its implementation team. In addition, with early involvement, the auditor can share best practices, recommend internal controls improvements, and offer observations on emerging trends that may be helpful to the company.

# Audit Committees

## Are You on Target for Section 404? (for companies with a 12/31/04 year-end)



### Key Considerations:

- Is your company where it needs to be for upcoming Section 404 reporting?
- Does your company have the skill sets for the required tasks?
- Is the company focusing on significant processes, risks, and controls?
- Are you involving your independent audit firm along the way to minimize the risk of surprises?
- Are you viewing Section 404 as an on-going project, and not a one-time event?

### Costs Associated With Section 404


It is clear that Section 404 compliance requires a significant investment in time, resources, and technology. Financial Executives International (FEI) informally surveyed its members in May 2003 about their cost estimates to implement Section 404. Not surprisingly, the costs reported were significant, in terms of both money and employee hours. Section 404 has increased the scope of effort required by all involved, particularly management, internal audit, the audit committee, and independent auditors.

Executives of forward-thinking companies recognize there can be strategic benefits from company investments to improve business processes and systems and the integrity of financial information, and they are working to leverage these investments over time. Benefits from a strategic assessment of internal controls can include lower organizational risk, increased productivity through the elimination of redundant activities, and improved process efficiencies.

### Looking to the Future

Changes as a result of Section 404 of the Sarbanes-Oxley Act will continue to impact public companies in the U.S. and abroad for years to come. Companies that early-adopt rigorous processes, as well as learn and apply best practices to their financial systems and controls, will be well prepared to manage their future.

### Questions

If you have any additional questions regarding Section 404 implementation, please contact your Ernst & Young client service partner. 

# Managing Whistleblower Processes

One year ago, *Time* magazine named “The Whistleblowers” as its Persons of the Year. The magazine praised Cynthia Cooper (WorldCom), Coleen Rowley (The FBI), and Sherron Watkins (Enron) for helping “remind us what American courage and American values are all about.”

Twelve months later, with corporate America now implementing the provisions of Sarbanes-Oxley that were passed by Congress and signed by the President, how has life changed for today’s potential whistleblowers?

There is much at stake. When handled appropriately by the corporation, whistleblower complaints can reinforce a culture of openness, and provide an early warning of potential serious fraud or weak internal controls that could undermine the company’s reputation. Handled poorly, the same complaints can undermine a company’s ethical foundation, leak sensitive issues to the media and regulators, and, ultimately, create a crisis for the individual whistleblower and the company.

Under Sarbanes-Oxley, the audit committee now bears the important new responsibilities for establishing whistleblowing procedures, including procedures for “confidential, anonymous submission(s)” of employee concerns about accounting issues.

The audit committee is not explicitly required to maintain the whistleblowing process, but it must consider what level of involvement is in the best interest of the shareholders. Some responsibilities can be left to management, some retained by the audit committee, some even delegated to a third-party resource.

Although there is no agreement about what type of whistleblower process to adopt, practices are evolving.


Some companies have provided a direct route for employee complaints to reach the audit committee members, while others have provided anonymous telephone hotlines (managed by the company’s own internal audit or legal departments, or sometimes by third parties). In the latter case, the audit committee simply

receives reports of the calls that come in to the hotline. There is no consensus on how often these reports should be submitted.

## What some of our clients are doing ...

- ✓ The general counsel takes the lead in making a preliminary evaluation and investigation of whistleblower complaints in almost two-thirds of companies surveyed, followed by the internal audit director and other specialized functions, such as the chief ethical or chief compliance officer.
- ✓ Half of all whistleblower activities are coordinated through an internal reporting system, while the other half uses a third party provider. Based on recent trends, the scale is tipping in favor of using a third party.
- ✓ The majority of companies have little or no filtering of information received, though the lead person or department often summarizes the information for the audit committee.
- ✓ Summary information is typically reported at each audit committee meeting, and the committees have established guidance to ensure significant or urgent matters are communicated, at least to the chair, immediately.

**Note:** In November 2003 we conducted an informal survey of the Ernst & Young partners who work with our largest global clients. The responses gathered reflect the point of view of approximately 40 clients.

Although new whistleblower processes continue to evolve, for the most part they have provided employees with the necessary communication channels to openly report potential financial wrongdoings. Legislation has provided the framework and most audit committees have responded, but given what is at stake, audit committee members need to continually review and challenge the effectiveness of the company’s process for responding to whistleblower complaints. 

## To be successful, the process for whistleblowers should....

- Allow legitimate allegations to receive the right attention
- Allow complaints to be treated differently depending on the associated risk
- Be communicated periodically to employees
- Be reliable

# Audit Committee Composition

New requirements regarding independence and financial literacy and expertise are adding to the challenge of attracting and retaining qualified audit committee members. As an audit committee member, what can your committee do to find qualified individuals?

The SEC, in finalizing its rule on implementing Section 407 of the Sarbanes-Oxley Act, has modified the term “financial expert” to “audit committee financial expert” (ACFE). This term suggests more clearly that the designated person has characteristics that are particularly relevant to the functions of the audit committee, such as: a thorough understanding of the audit committee’s oversight role, experience with preparing or evaluating financial statements, an understanding of internal controls, and the ability to ask the right questions to determine whether the company’s financial statements comply with generally accepted accounting principles.

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## What some of our clients are doing ...

- ✓ More than 80% of companies surveyed indicated that the audit committee chair qualifies as an audit committee financial expert (ACFE). Of the remaining 20%, close to half indicated they intend to appoint a chairperson who meets the designation.
- ✓ Of the companies whose chair is designated as an ACFE, 10% indicated that this person had been appointed within the last year.
- ✓ A few companies stated that their entire audit committee qualifies as ACFEs and they are adopting this as a standard. Other companies are leaning toward not naming an ACFE at all.

**Note:** In November 2003 we conducted an informal survey of the Ernst & Young partners who work with our largest global clients. The responses gathered reflect the point of view of approximately 85 clients.

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CFO candidates for board appointment are starting to question whether they are being brought onto the board simply to fulfill the role of ACFE. The SEC’s final rule permits a CEO who has the necessary education and experience (experience may be obtained from “active supervision” of a CFO) to qualify as an ACFE, which expands the pool of available resources.

It is also important to find other audit committee members who can ask penetrating questions that cause the ACFE to stop and think outside his or her frame of reference.

Two groups sometimes overlooked for committee membership are active partners in a venture capital firm and industry experts. While these types of candidates may not qualify as an ACFE, they can bring extensive experience and industry knowledge, they tend to ask probing questions, and they can have other relevant skills that complement the experience of the ACFE.



An unintended benefit of the ACFE requirement may be to create additional opportunities for nominating committees to include more women and minority candidates in their ACFE searches.

Beyond finding ACFEs, another obstacle for identifying qualified audit committee candidates is the time commitment required of committee members. Many audit committees have doubled the amount of time needed to perform its duties. Additionally, some potential candidates have been advised by their personal and/or corporate counsel against joining the audit committee to mitigate their risk of serving on a board.

Moreover, the SEC recently ruled that “if an audit committee member simultaneously serves on the audit committees of more than three public companies, and the listed company does not limit the number of audit committees on which its audit committee members serve, then in each case, the board must determine that such simultaneous service would not impair the ability of such member to effectively serve on the listed company’s audit committee and disclose such determination in the company’s annual proxy statement...”

All board members should be encouraged to serve on the audit committee. Suggested practice recommendations from senior audit committee members reveal they prefer not to serve on boards with directors who refuse to join the audit committee. They indicate that this situation reduces the opportunity for the rotation and development of board members, and introduces unwanted rigidities to committee membership.

One way to address these concerns is through board education programs. At a minimum, each board member should strive to attend one board education course every three to five years. Leading-edge boards are also insisting on development plans for each director, and building in a broader look at the development opportunities available for each committee role. 📄

# Forward View



## Excessive executive compensation: the next campaign in corporate governance

With Sarbanes-Oxley now in implementation mode, regulators and legislators are looking to the next issue for improving America's corporate governance. Their target: excessive CEO pay, and the boards of directors that permit it.

Consider these recent developments:

- On the first anniversary of the Sarbanes-Oxley Act last July, SEC Chairman William Donaldson told the National Press Club that the SEC was committed to stamping out “transactions that are disguised as rewards for entrepreneurship or superior management but that in fact provide risk-free excessive compensation...”
- In October, William McDonough, chairman of the PCAOB, told the National Association of Corporate Directors, “Americans are telling their elected representatives that they are angry, and the thing they are angriest about is executive compensation.... As corporate directors, you should think long and hard about the compensation of the executives who head the corporation you are sworn to protect.”

The process has started. The question is, will the private sector be able to get executive compensation under control before public pressure turns a few straws in the wind into new laws and regulations?

The spotlight is shining first on compensation committees. The New York Stock Exchange is demanding reform, including ensuring the independence of committee members themselves and providing new powers to hire consultants independent of management to assist in the evaluation of executive compensation.

However, audit committees are also reviewing their oversight responsibilities on compensation. Excessive or unfair executive compensation contains two types of risk for the corporation:

- **Conflict of interests** around performance targets that trigger year-end bonuses for executives, and provide perverse incentives for “management” or manipulation of earnings.

- **Damage to corporate reputation** from disclosure of faulty processes for agreeing compensation, and the subsequent loss of confidence by the financial community. What starts out as a reputation risk may end as a financial risk.

Many audit committee chairs believe that audit committees must become more active in the compensation arena. They see the audit committee as the committee of last resort for managing risk. They are trying to determine when CEO compensation becomes an enterprise-wide risk in itself, and how they can play a role in vetting compensation committee proposals without damaging board collegiality.

One audit committee chair described the problem as “decisions in the compensation committee that the audit committee is not aware of until the decision has been made. As compensation is the ultimate [measure] of behavior, there needs to be better linkage between committees and discussion of behavioral and performance-related issues.”

The issue is how to get the audit committee involved before the compensation committee reports to the full board, and directors are pushed into a straight up or down vote on the proposal. Few boards allow a line-item veto.

The second campaign in the corporate governance movement has begun. Audit committee members have a responsibility to decide now how they will answer the inevitable question: Where do you stand on executive compensation?

*Forward View is written by Tapestry Networks. Ernst & Young works with Tapestry Networks to orchestrate private dialogues, including the Audit Committee Leadership Network, and develop practical insights and solutions to enhance the functioning of financial markets.*

# Looking Ahead

As you and the other members of your audit committee begin to deal with everything associated with year-end reporting and filing, here's a look at some of the resources you will receive from Ernst & Young:

## Early 2004


Join us for a Thought Center Webcast and hear leading audit committee members and E&Y professionals discuss:

- Section 404: Implementation Implications for Audit Committee Members

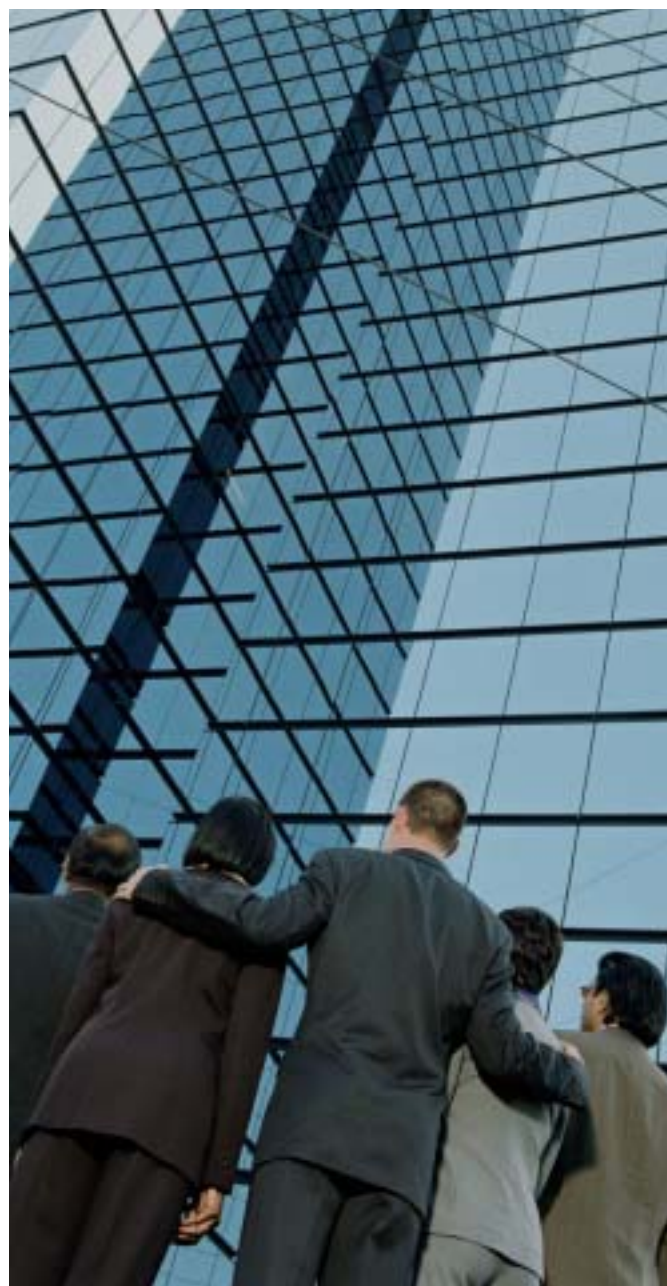
## March 2004

Some of the topics in the next issue of *BoardMatters Quarterly* will include:

- Enterprise Risk Management - what does this mean to audit committees?
- A review of audit committee charters
- The changing role of internal audit

If you have suggestions for other topics, or have feedback on this issue, please send them to Lisa Hallman at [lisa.hallman@ey.com](mailto:lisa.hallman@ey.com). 

**For more information, go to**  
**[eyonline.com/auditcommittee](http://eyonline.com/auditcommittee)**



## New Developments

On November 4, 2003, the Securities and Exchange Commission approved new rules proposed and adopted by the New York Stock Exchange (NYSE) and NASDAQ requiring widespread strengthening of corporate governance standards for listed companies. The new rules establish a stricter, more detailed definition of independence for directors and require the majority of members on listed companies' boards to satisfy that standard.

In addition, the rule changes include a number of provisions that require and facilitate independent director oversight of processes relating to corporate governance, auditing, director nominations, and compensation.

Further information on these new rules may be found in Ernst & Young Online. To request access, please contact your Ernst & Young representative or your local Ernst & Young office.

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