March 2004

BoardMatters Quarterly

Critical Insights for Today's Audit Committee

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The relationship between the audit committee, auditor, and management continues to grow and evolve. In some cases, what was once primarily a two-way communication between the auditor and management has evolved into a three-way dialogue that requires openness, candor, and informative discussions.

This issue of *BoardMatters Quarterly* provides information on several hot topics that are being discussed in boardrooms across America, including:

- Risk Management—taking a comprehensive view of risk
- Re-evaluating your audit committee charter
- Assessing "Tone at the Top" from the bottom up
- Key trigger points around FIN 46

Through Ernst & Young's work with the Audit Committee Leadership Network, a group of audit committee chairs from some of America's leading companies, we will provide you with knowledge, insights, and leading practices on the key issues and emerging trends that you face each day. We hope this information stimulates dialogue and helps you look toward the future.

Please feel free to contact us with your feedback on this 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. ✔

Risk Management

Taking a Comprehensive View of Risk

Audit committee members often worry most about the risks that they are not aware of because they either have not been identified or foreseen, or have not appropriately been assessed, prioritized, and reported to the audit committee. Although the concern of unidentified or unforeseen risks can never be entirely eliminated, proactive audit committees can reduce this concern by influencing management to carry out a comprehensive risk management process that will help prevent potential blind spots and risk coverage gaps.

While there are a variety of existing comprehensive risk management processes and frameworks, an effective process generally should contain the following six elements:

- **Risk Strategy** – the board and management should provide guidance on the appropriate strategy and approach to risk management across the organization
- **Governance** – the board should delegate day-to-day governance through an oversight function that includes a Chief Risk Officer (CRO) and/or business risk steering committee
- **Risk Management Functions** – integration of risk management functions occurs through a coordinated effort of centralized and decentralized risk management professionals across the organization
- **Risk Management Processes** – the organization must have effective processes for identifying, assessing, managing, monitoring, and communicating risks on an enterprise-wide basis
- **Technology** – effective systems are needed to provide access to risk information and support risk management processes
- **Culture and Capability** – everyone in the organization must be attuned to the risk culture and have the capability to effectively manage risks

The Role of Audit Committees in Risk Management

As in the past, many boards continue to delegate the primary oversight responsibility over risk management activities to the audit committee. In fact, the new NYSE corporate governance rules require that audit committees participate in certain risk management oversight activities by requiring them to discuss with management its risk assessment and risk management policies, including major financial risk exposures and the steps management has taken to monitor and control such exposures. Traditionally, audit committees may have focused their time and efforts on financial reporting risks and relied heavily on internal audit to oversee operational and compliance risk management processes. Because of the new regulations and significant proliferation of risks—especially reputation risks—audit committees are taking a more active role in obtaining a comprehensive view of risk across the organization, understanding risk management decisions, and seeking assistance from independent specialists, such as other risk advisors, to assist with the evaluation of risk management strategies and processes.

Identifying Risks

In today's environment, audit committees can no longer take a reactionary approach to their risk management oversight responsibilities. Audit committees should proactively request management, internal auditors, and external auditors to discuss and report on the most significant risks facing the enterprise and the steps taken by management to control and manage these risks. Additionally, audit committees need to understand the company's risk assessment process used to identify and prioritize the most significant risks to the organization. To be effective, the risk assessment process should be rigorous and comprehensive, covering all major processes and functions. Further, the risk assessment process should continually evaluate the impact of changing business strategies and market and environmental conditions on the risk profile of the company.

The following sources can assist audit committees in performing their oversight responsibilities by providing multiple viewpoints regarding major risks:

- Management's assessment of significant risks and the sufficiency of controls and associated reports provided to the board of directors
- Evaluations of risk and control systems performed by internal auditors
- Results of internal control procedures or other audit committee-requested procedures performed by the external auditors
- The result of special investigations or other activities commissioned by the board or the audit committee
- Inquiries and discussions with the CEO (and CRO, if applicable) and department/function directors, such as the CFO, general counsel, director of tax, CIO, COO, CDO, and others

Risk Management and Section 404

Over the last year, public companies have started to address market and regulatory concerns about the effectiveness of their controls and risk management processes through their implementations of Section 404 of the Sarbanes-Oxley Act of 2002. Section 404 requires management to examine, make improvements where necessary, and assert to the effectiveness of their internal control over financial reporting.

Risk Management Coverage Model

Section 404 is driving improvements in internal controls and risk management over financial reporting systems and processes. It is not, however, forcing companies to assess the effectiveness of their controls and risk management over operational and compliance systems and processes, or the reliability of their overall risk management program. Leading practice companies have recognized this gap and have either expanded their Section 404 implementations to also review the effectiveness of their operational and compliance controls and risk management processes, or plan in the future to sequentially move to these other categories of risk once they have successfully completed their 404 implementations.

Achieving Sufficient Risk Coverage

Clearly, the focus now, and over the next several months, is on implementing and complying with Section 404. Many companies have shifted key risk management resources, including risk managers and internal auditors, away from operational and compliance oversight responsibilities toward Section 404 activities. And audit committees are heavily engaged in monitoring management's Section 404 implementation projects.

Given the significant risks associated with Section 404, management and the audit committee cannot afford to have a major misstep in the implementation project. By the same token, management and audit committees cannot lose sight of their roles and responsibilities over other operational and compliance controls and risks. To this end, it is critical that audit committees in their oversight role understand and evaluate the effectiveness of how the company achieves sufficient coverage, not only for its financial reporting controls and risks, but also for its major nonfinancial controls and risks through the efforts of internal audit, external audit, and other risk advisors.

Audit committees' primary role will continue to focus on safeguarding the objectivity and integrity of financial reporting and related internal control processes. This will not change. However, what *is* changing is the role of audit committees relating to risk management of operational, compliance, and other risks that traditionally may have been outside their purview. In today's environment, the line between these other categories of risk and financial reporting risks is blurring, compelling audit committees to expand their oversight to a more comprehensive view of risks and controls. ✔

The Audit Committee's "Call to Action"

- *Understand your company's risk management process* – is it comprehensively covering all major processes and functions? Is sufficient audit coverage achieved across all major controls and risks—financial reporting, compliance, and operations?
- *Be proactive* – you may need to evaluate the effectiveness of the risk reporting information that is typically provided by internal audit, external audit, and management.
- *Ask questions* – request that risk management discussions be added to your meeting agenda. Identify any unknown risks or risk gaps in your organization and determine if your company's risk is being managed at an acceptable level.
- *Examine your company* –find out if the culture promotes and rewards an open and positive discussion of risks. Risks should be proactively managed and mitigated, and there should be a common understanding of how risk aligns with overall business goals and strategy.
- *Examine your industry and markets* – companies in the same industry and markets typically are exposed to the same kinds of risks and uncertainties.

An Ernst & Young Survey Shows:

- A majority of leading companies surveyed– 59%–recognized that they do not have a comprehensive process for managing risks. Their organizations continue to evaluate risk management activities within silos.
- Only 18% have a risk management function responsible for monitoring and reporting to executive management.
- The majority of CEOs and CFOs believe they have significant gaps in risk coverage.

Note: We conducted a survey of the risk management practices of 52 companies spanning various industries and sizes.

Communicating Audit Committee

Re-evaluating Your Audit Committee Charter for the New Rules

The Sarbanes-Oxley Act of 2002 (the Act) has had a far-reaching impact on corporate governance. For example, it has made the audit committee's role more critical as it relates to providing oversight of the financial reporting process. Since the Act was established, there have been several additional fundamental changes pertaining to the audit committee's role. In particular, the Act and the new New York Stock Exchange (NYSE) listing requirements have introduced new roles and responsibilities for audit committees that are starting to be reflected in companies' audit committee charters. The charter, which defines the governance model of the audit committee, is key in establishing the scope and process by which the audit committee carries out its responsibilities and executes its oversight role.

The SEC's Exchange Act Rule 10A-3, pursuant to Section 301 of the Act, provides standards that listed company audit committees are required to follow. In response, the major national securities exchanges and associations have amended their listing standards to conform to the SEC rule, and the SEC approved those revised listing standards. Listed issuers must be in compliance with the new listing rules by the earlier of their first annual shareholders meeting after January 15, 2004, or October 31, 2004. Small businesses and private issuers have until July 31, 2005.

Understanding the Changes to the Listing Standards

The stock exchanges and associations, in particular the NYSE, have made significant changes to their corporate governance-related listing standards. Previously, the NYSE's listing standards required that there be a written audit committee charter that was reassessed annually, and the charter had to specify: 1) the scope of the committee's responsibilities and how it carries out those responsibilities, 2) the accountability of the independent auditor to the board of directors and the audit committee, and 3) the audit committee's responsibility for receiving communications from the independent auditor regarding the auditor's independence.

With the recent revisions to the listing standards, the level of detail mandated to be included in the audit committee charter of an NYSE-listed company has substantially increased. For example, the new standards state that the "duties and responsibilities" section of the charter must include the SEC Rule 10A-3 requirements regarding the independence of audit committee members, the responsibilities relating to registered public accounting firms, complaint procedures, the authority to engage advisors, and funding for the audit committee. In addition, the NYSE made further changes to strengthen issuer accountability, integrity, and transparency.

Considering Other Duties and Responsibilities

While not required by the listing standards to be in the audit committee charter, certain other duties and responsibilities might be considered for inclusion, either because they are otherwise required by the listing standards (e.g., audit committees must have at least three members) or by other regulation or standard (e.g., communications required by Statement on Auditing Standards No. 61, "Communications With Audit Committees"), or because they may be a leading practice (e.g., audit committee members may serve on only three public company audit committees simultaneously). In addition, the NYSE listing standards contain a significant amount of commentary regarding practices that the audit committee should perform or consider performing.

Evaluating Your Charter

The new listing standards necessitate a re-evaluation of audit committee charters. As you reassess your company's charter, we encourage you to obtain the advice and input of legal counsel and tailor the charter as necessary to meet your company's overall corporate governance policies and guidelines.

For a more detailed example of an audit committee charter that addresses requirements as well as leading practices, please visit the Audit Committee Library on Ernst & Young *Online*, a secure online resource that contains several additional useful materials for audit committee members. Please contact your Ernst & Young partner to request access to Ernst & Young *Online*. ✔

Nasdaq and AMEX

The previous listing standards of the Nasdaq and AMEX were similar to those of the NYSE. Their new listing standards carry forward their previous requirements, except that they specify the accountability of the independent auditors to the audit committee. Their new listing standards also require that the charter include the specific audit committee responsibilities and authority set forth by SEC Rule 10A-3.

Additionally, the AMEX rules require that the charter describe the audit committee's purpose of overseeing the accounting and financial reporting processes of the issuer and the audits of the financial statements of the issuer, and that the audit committee review and reassess the adequacy of the charter annually.

Responsibilities

The NYSE listing standards require that the audit committee's charter specify the committee's purpose, which, at a minimum, is to (A) assist board oversight of (i) the integrity of the company's financial statements; (ii) the company's compliance with legal and regulatory requirements; (iii) the independent auditor's qualifications and independence; and (iv) the performance of the company's internal audit function and independent auditors; and (B) prepare an audit committee report as required by the SEC to be included in the proxy statement. The charter should also address the committee's duties and responsibilities, including certain minimum requirements.

The duties and responsibilities that are required to be included in an NYSE-listed company's charter include the SEC Rule 10A-3 requirements indicated above, as well as the following:

- Review reports by independent auditor describing the firm's quality control procedures; any material issues raised by quality-control reviews, inquiries, or investigations (in the last five years) relating to independent audits carried out by the firm; and (to assess auditor independence) all relationships between the firm and the company
- Discuss annual and quarterly financial statements with management and independent auditor, including Management's Discussion and Analysis
- Discuss earnings press releases, as well as financial information and other earnings guidance
- Discuss policies with respect to risk assessment and risk management
- Meet separately and periodically with management, internal auditors, and independent auditors
- Review with independent auditor any audit problems or difficulties found and management's response
- Set clear hiring policies for current or former employees of the independent auditor
- Report regularly to the board of directors

Examples of other duties and responsibilities that may be considered in the charter are listed below:

- Evaluate the lead partner of the independent auditor
- Consider the process for rotation of the partner on the account
- Pre-approve all audit and non-audit services
- Discuss scope and audit plan with auditors
- Review accounting adjustments noted by the auditors that were not recorded
- Review any internal control-related letter prepared by the auditors
- Review major issues regarding accounting principles and financial statement presentation
- Discuss with management and the auditors any significant financial reporting issues and judgments
- Consider the effect of regulatory accounting initiatives
- Consider judgments of management and the independent auditors about the quality, not just the acceptability, of accounting principles
- Discuss the clarity of disclosures in the financial statements
- Discuss with the independent auditor any communications required by professional standards
- Receive a report from the independent auditors on critical accounting policies, all material alternative accounting treatments discussed with management, and other material written communications between the independent auditors and management
- Review and approve all related party transactions
- Review management's assessment of the effectiveness of internal control over financial reporting and the related independent auditor's report
- Discuss with management and the auditors the adequacy and effectiveness of internal control over financial reporting, including significant deficiencies or material weaknesses identified in connection with management's certifications, and discuss any significant changes in those controls
- Review the company's Code of Conduct and monitoring programs
- Receive corporate attorneys' reports of evidence of a material violation of securities laws or breaches of fiduciary duty
- Discuss the risk of fraud

Also, certain items should be addressed in the audit committee charter even though they are not specified in the rules, such as the composition of the audit committee and audit committee independence.

Forward View

by Tapestry Networks

Assessing "Tone at the Top" from the Bottom Up

SEC Chairman William Donaldson has declared that restoring the investing public's confidence in America's corporations will require a shift in the "tone at the top."

Meanwhile the Public Company Accounting Oversight Board (PCAOB) is inspecting the "tone at the top" of the audit firms. As Chairman William McDonough revealed last year, "The Board and our inspectors want to know if the message of doing the right thing is reaching the rank and file."

The important questions for audit committees to consider are what responsibility they have to influence the tone at the top, and what actions they should take based on that responsibility. Should the audit committee seek to ensure that "the message of doing the right thing" is actually reaching the "rank and file" in their corporations?

The PCAOB may be on to something. After all, what is the use of "tone at the top" if it does not permeate the culture of the organization and impact behavior at every level? This may be an opportunity for senior management to test how far their values and messages are shaping the decisions of individual employees who influence the stakeholder experiences that impact the corporation's reputation. Call it reputation risk measurement if you like.

Many corporations—including those that show up regularly in the *Fortune* 100 Best Companies to Work For survey—do measure employee commitment to the business and their confidence in its leaders. High levels of employee commitment have been positively correlated with lower employee turnover, higher sales figures, and better control of operational costs. In a recent series of discussions with CEOs, half told us they were using employee survey data to measure various aspects of leadership behavior, ethics, and compliance. Indeed, one of them made an explicit link between the results of the survey and the incentive compensation of senior managers.

One example of a leading measurement practice is a mid-market NYSE-listed company in the software sector that gathers employee feedback through a demographically representative panel consisting of 10% of the workforce. Employees complete a quarterly online survey covering their commitment to the organization and their confidence in leaders. Results are presented by management to the board, as part of a "balanced scorecard," whereby financial and nonfinancial measures are used to track performance.

Many corporations might balk at the potential cost of setting up such a process, but even the most basic employee feedback could help determine whether "the message of doing the right thing" is permeating through the organization. If no such data exists, or management does not wish to share it with the audit committee, that may itself provide a signal. After all, as the cliché has it, "what gets measured, gets done."

Many audit committee chairs are proud of their instincts when it comes to oversight of management. Adding data on the attitudes and concerns of employees may prove an invaluable tool not only for the audit committee to assess the "tone at the top," but also for management to improve corporate performance.

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 help enhance the functioning of financial markets. ✔

Looking Ahead

Thought Center Webcasts

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

- *Implementing Section 404*: Implications for Audit Committee Members (April 2004)
- *Enterprise Risk Management* (June 2004)

Additionally, go to www.ey.com/webcast to watch a rebroadcast of a recent Thought Center Webcast on *Stock-Based Compensation*.

June 2004

Some of the topics in our next issue will include:

- *Audit Committee Effectiveness*: *Lessons Learned From 404*
- *Influence of Shareholder Advocacy Groups*
- *Update on PCAOB Developments*
- *Section 302 and Risk Management*
- *Stock Option Accounting*

If you have feedback or other suggestions, please send them to Lisa Hallman at lisa.hallman@ey.com.

Key Accounting Issues: FIN 46

Keeping Up With Variable Interest Entities (VIEs)

In January 2003, the FASB issued Interpretation No. 46, Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin (ARB) No. 51 (FIN 46). More than a year later, many companies continue to grapple with FIN 46. FIN 46 generally applies to all entities and industries, with some limited exceptions. Even after the first year of implementation, FIN 46 continues to have widespread implications because of its broad scope. Keeping up with FIN 46 and VIEs is important, because the complex provisions of FIN 46 can result in unintended consequences, such as consolidation or deconsolidation of entities, earnings volatility, or debt covenant violations. Do you know where your variable interest entities are?

Before FIN 46, many variable interest entities (VIEs), commonly referred to as special purpose entities (SPEs) or off-balance sheet structures, were created for a specific business reason (e.g., to facilitate securitization, leasing, real estate development or operation, hedging, research and development, reinsurance, or other transactions or arrangements), often unrelated to the company's principle business activities. Companies that formed these off-balance sheet structures followed what limited guidance existed at that time when determining whether or not to consolidate the entities. In direct response to SPE financial reporting abuses, the FASB developed a new consolidation model so that, when appropriate, these SPEs will be reported in the consolidated financial statements of the parties that are exposed to a majority of their risks and rewards.

What is a Variable Interest?

Variable interests are contractual, ownership, or other money interests in an entity that change with changes in the entity's net asset value. Examples of variable interests include equity investments, loans, leases, derivatives, and guarantees.

What is a Variable Interest Entity (VIE)?

VIEs are subject to the FIN 46 variable interests consolidation model — and consolidation is not determined based on ownership of the entity's voting stock. In general, a VIE is an entity that has:

- ✔ An insufficient amount of equity to permit the entity to finance its operations without additional subordinated financial support provided by other parties,
- ✔ A group of equity owners that are unable to make significant decisions about the entity's activities through voting or similar rights, or
- ✔ Equity that does not absorb the entity's losses or receive the benefits of the entity.

FIN 46's consolidation model—the variable interests model—comes into play if a company holds variable interests in a VIE. Generally, an entity is considered a VIE if it lacks sufficient equity to absorb an entity's "expected losses," or if its equity holders lack adequate decision-making ability, the obligation to absorb losses, or the right to receive returns. Variable interests can include contractual, ownership, or other interests in the VIE that expose the holder to risks and rewards. For instance, variable interests might include equity investments, loans, leases, derivatives, guarantees, and other instruments whose values change with changes in the VIE's assets. Any of these instruments may require its holder to consolidate the VIE.

Examples of Arrangements Subject to FIN 46:

- ✔ Investment Partnerships
- ✔ Real Estate Partnerships
- ✔ Commercial Paper Conduits
- ✔ Leasing Arrangements
- ✔ Venture Capital/Private Equity Funds
- ✔ Joint Ventures
- ✔ Securitization Vehicles
- ✔ Insurance and Reinsurance Entities
- ✔ Research and Development Ventures

Almost any legal structure used to hold assets or conduct activities might be considered a VIE, and therefore falls within the scope of FIN 46. Potential VIEs could include: corporations, partnerships, limited liability companies, majority-owned subsidiaries, and grantor trusts, to name a few. Almost every legal entity must be evaluated to determine whether it is a VIE and whether the company holds variable interests in the VIE.

Because of the implementation challenges encountered with FIN 46, numerous FASB Staff Positions (FSPs) were issued throughout 2003. And, in December 2003, the FASB issued a revised FIN 46, which supercedes the original interpretation issued in January 2003. Effective dates for adoption of the provisions of FIN 46 differ for variable interests based on whether the interests are held (1) by public companies and relate to SPEs, (2) by public companies that are small business issuers, and (3) by non-public companies. All public companies must apply FIN 46 to variable interests in SPEs (created before February 1, 2003) no later than the end of the first reporting period that ends after December 15, 2003 (as of December 31, 2003, for calendar-year enterprises). A

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public company that is not a small business issuer should apply the revised interpretation's provisions to all variable interests in non-SPEs (created before February 1, 2003) no later than the end of the first reporting period ending after March 15, 2004 (March 31, 2004, for a calendar year end company).

Identifying all potential variable interests and VIEs is challenging enough, but FIN 46 also requires calculations (often complex) in order to determine who should consolidate the VIE. Estimates of a number of possible future outcomes of the VIE are required to be modeled, and the probability of each outcome must be assigned. These estimates can be extremely subjective and difficult, particularly because many transactions involve complex terms.

Despite the complications of FIN 46, off-balance sheet financing will remain a viable tool, as securitizations, synthetic leases, and project finance structures can be useful to their participants. However, companies should provide transparent financial reporting of off-balance sheet transactions to enable investors to clearly understand these often complicated structures. ✔

Understanding the Company's Plan to Comply

- ✔ Has the company assembled a team to thoroughly understand the transactions and potential implications of FIN 46?
- ✔ Have all variable interests been identified?
- ✔ Has it been determined whether an entity is a VIE and, if so, which enterprise is the primary beneficiary?
- ✔ Have estimates been made of a significant number of possible future outcomes of each entity, as well as the probability of each outcome occurring?
- ✔ Have expected losses and expected residual returns been calculated?
- ✔ Have triggering events been considered that would require reevaluating whether an entity is a VIE? Has a calculation of expected losses and residual returns been performed based on the facts and circumstances at the date of such events?
- ✔ Have impacts to the financial statements and related disclosures been assessed?

For more information, go to
eyonline.com/auditcommittee