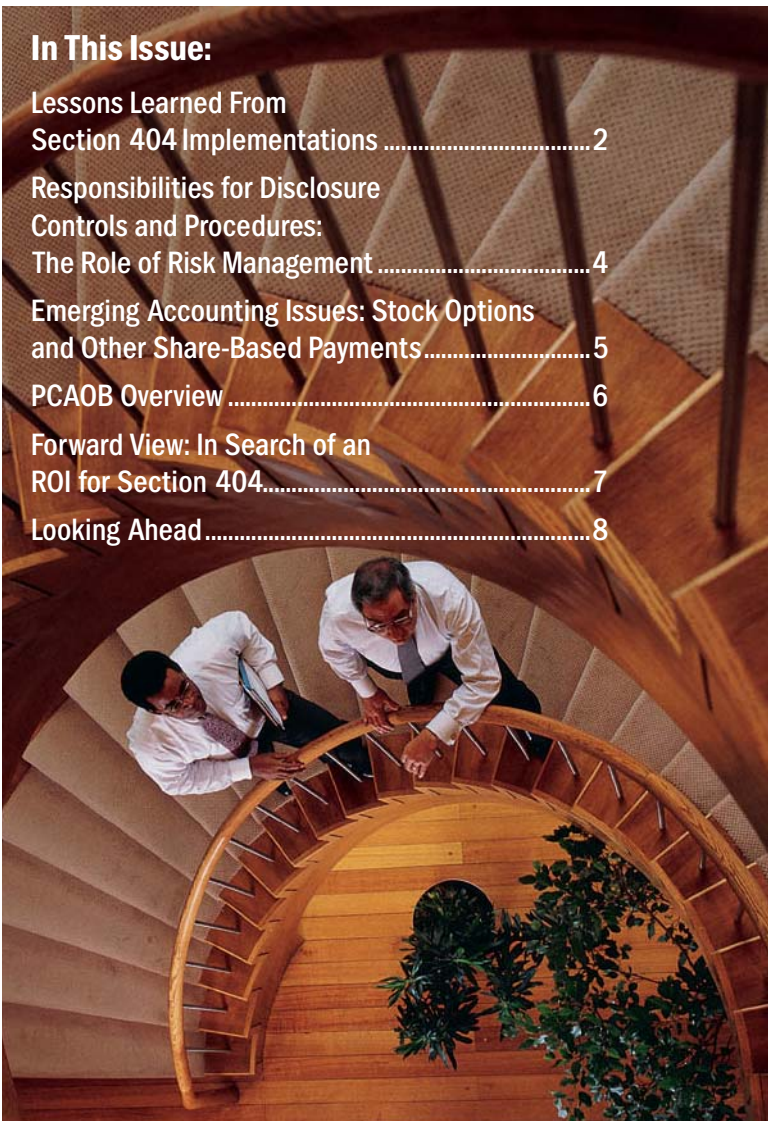


BoardMatters Quarterly

Critical Insights for Today's Audit Committee



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Audit committees continue to play an increasingly important role in corporate governance. Your committee needs to gather more information about the company's risk, operations, and financial performance as you oversee the overall financial reporting process. We hope that this publication is a valuable tool in your efforts.

This issue of *BoardMatters Quarterly* provides information on several topics that you and the other members of your board may be thinking about, including:

- Lessons learned from Section 404 implementations
- Responsibilities for disclosure controls and procedures
- An overview of the PCAOB
- Stock options and other share-based payments
- The return on investment for Section 404

With less than six months to go until many SEC registrants in the United States must finish documenting, assessing, remediating, and testing their internal controls, we hope you find these articles informative and useful.

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. ✓

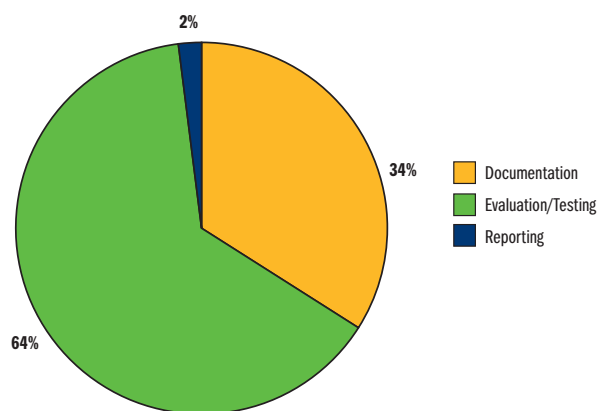
Lessons Learned From Section

Key Questions to Ask When Evaluating Your Company's Readiness:

1. Are you satisfied that there is a clearly identified process owner and that he or she is being held accountable?
2. Does the approach have long-term sustainability, or does it have more of a project mentality?
3. Are the right people on the team? Is internal audit being used appropriately?
4. Are efforts prioritized around what needs to be in place to get this done this year?
5. Are there plans to conduct "dry-run" activities for high-risk areas?
6. Is there regular communication between management and the independent auditor?
7. Are procedures in place to manage significant events occurring near year end (i.e., major IT projects, M&A activity, etc.)?

What some of our clients are doing...

Approximately two-thirds of companies surveyed with a 2004 implementation deadline have moved on to the evaluation and testing phase. Almost one-third are still documenting their systems, processes, and controls.



Note: In April 2004, we conducted an informal survey of Ernst & Young clients. The responses gathered reflect the point of view of approximately 100 clients.

Implementing Section 404 of the Sarbanes-Oxley Act continues to be one of the most challenging initiatives facing companies today. The Public Company Accounting Oversight Board (PCAOB) recently published its final auditing standard relating to Section 404, which emphasizes the importance of the audit committee's oversight role as it relates to the company's internal control over financial reporting. Although management is responsible for performing the assessment of internal control required under Section 404, the audit committee should be satisfied that management's internal control assessment is thorough and well-documented, that judgments made are reasonable, and that all parties have done a quality job.

Ernst & Young has been gathering Section 404 implementation information from scores of companies over the past several months—from "early adopter" global organizations, to middle market companies, to private companies that are voluntarily electing to comply with Section 404. We have observed management's activities to report on the effectiveness of their companies' internal control systems, and offer some lessons learned and observations from these experiences to help you effectively carry out your oversight role.

Company Ownership

Leading companies have appointed a strong, accountable internal owner to oversee the Section 404 implementation with the necessary resources and sponsorship from top management and the audit committee. In contrast, management at some of the companies surveyed is trying to increase the audit committees' comfort level by obtaining external resources to address the requirements of the process. In reality, the process may not be adequately internalized by giving it the strong, skilled, dedicated leadership and resources necessary for long-term success. While we are currently in the first year of implementing Section 404, successful implementation requires that companies be focused on both the short-term and the long-term funding of the effort with an appropriate budget, and designating a dedicated resource to prioritize team efforts and oversee the program with suitable accountability.

Coordination

Management must take responsibility for developing its own approach to performing an evaluation of internal control over financial reporting. In many companies, this is being done using a combination of internal resources and outside service providers. While on the surface it seems obvious that the approach should be

The audit committee should be satisfied that management's internal control assessment is thorough and well-documented, that judgments made are reasonable, and that all parties have done a quality job.

404 Implementations

a coordinated effort between the company, the outsider provider, and the independent auditor, in reality many companies have taken a silo approach with minimal coordination between these groups, resulting in an increased scope due to the need for re-work. An effective way to foster coordination is through the establishment of a 404 Steering Committee that includes management, the independent auditor, and the outside provider.

Audit committees should insist that there is early coordination and agreement on the approach with the independent auditor, to minimize any surprises on the back-end. Audit committees should also ensure there is regular communication with the independent auditor to receive timely validation throughout the implementation process.

Getting Down to Basics

Leading companies have approached Section 404 with the desire to turn their project efforts into more than a compliance exercise, and to look for ways to gain value from their processes. For example, a company might make its business processes and controls documentation centrally located and easily updateable, and use that data for training new employees. However, before focusing on long-term/value-add, it is important to ensure the fundamentals are in place for year-one compliance.

The level of effort for year-one implementation has been much greater than originally planned, with most companies seeing more than a 25% increase in scope from original estimates. Effectively managing costs related to this increase means prioritizing and focusing on requirements.

Ongoing Communication

Over the last year, communication with the audit committee regarding the 404 implementation effort by management and the independent auditor has primarily happened on a quarterly basis. As companies draw closer to their compliance deadline, discussions are progressing to a more frequent status update, typically monthly.

During the early phases of implementation, these discussions centered on reviewing the determination of significant accounts, budgets, geographic and location coverage, timelines, and sampling approaches. As companies move further into the testing phase, these meetings are being used to conduct open dialogue on implementation issues. The key objectives are to provide the audit committee with the status on the level of readiness, the testing

strategy being deployed, and communication on whether any significant deficiencies or material weaknesses have been uncovered. Communications also include a discussion of the process used and the timetable for performing remediations when control deficiencies have been identified.

The audit committee should determine whether management has effective procedures and sufficient resources for reporting (including a consistent definition for what constitutes a material weakness or significant deficiency) and remediating control deficiencies, and if enough time has been included in the schedule to allow for re-testing after remediation.

Using the Right Resources

The need for specialized resources is becoming more important. Estimation processes, especially those related to tax, are generally not well documented and require team members with the appropriate subject matter knowledge to address them. Companies are being challenged to have the appropriate IT resources, both for documentation of controls and, more importantly, for testing and remediation of IT controls. In-house IT resources may not be sufficient to address the scope of testing necessary in the areas of IT general controls and application controls.

Many companies have found that the skills necessary to document and test controls reside primarily within the internal audit group. One benefit of extensive involvement by internal audit is the potential reduction in work required by the independent auditor. (PCAOB Standard No. 2 permits the independent auditor to use the relevant work of highly competent and objective internal audit to a greater extent than management personnel.) However, many audit committees are concerned that the involvement of internal audit in the Section 404 implementation will impact their ability to complete their standard internal audit plan for the year. Companies are focusing on ways to effectively manage internal audit resources and leverage their skills to the broader organization.

Understanding these and other issues related to Section 404 implementation is important as companies move toward year-one compliance of reporting on internal controls. For additional information, refer to Ernst & Young's most recent publications on Section 404—*Section 404 Internal Control Reporting: Implementation Experiences* and *Emerging Trends in Internal Controls – Second Survey*. ✓

Responsibilities for Disclosure Controls and Procedures

The Role of Risk Management

Management's Responsibilities

As required by Section 302(a) of the Sarbanes-Oxley Act of 2002 and related SEC rules, a company's CEO and CFO must certify the information contained in each quarterly and annual report. In addition to certifying the financial statements and other financial information included in the report, the certifying officers must also state that they are responsible for establishing and maintaining "disclosure controls and procedures" sufficient to ensure that the financial and non-financial information required to be disclosed in SEC filings is recorded, processed, summarized, and reported within the specified time periods. And, they must state that they have disclosed any material changes in internal control over financial reporting that occurred during the most recent quarter.

Additionally, with the pending amendments to expand and accelerate Form 8-K reporting requirements, management will need to evaluate the effectiveness of its disclosure controls and procedures to meet the new requirements, which become effective August 23, 2004.

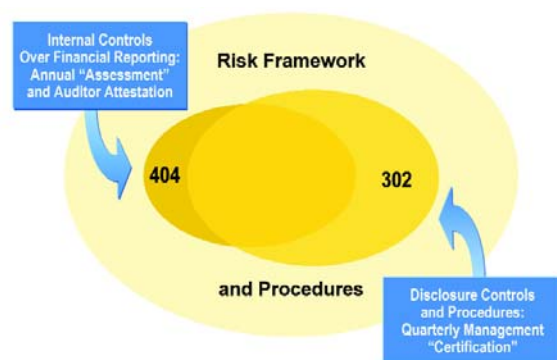
The Audit Committee's Responsibilities

For many organizations, the audit committee has primary oversight responsibility for ensuring that management has effective "disclosure controls and procedures" to ensure the quality, timeliness, and accuracy of all disclosures, including disclosures relating to risks and uncertainties. Under the NYSE corporate governance rules, the audit committee should, among other matters, discuss the annual audited financial statements and quarterly financial statements with management and the independent auditor, including MD&A disclosures. They are also required to discuss earnings press releases as well as financial information and earnings guidance provided to analysts and rating agencies.

Defining Disclosure Controls and Procedures

The SEC uses the term "disclosure controls and procedures" to make it explicit that the controls contemplated by Section 302 are intended to embody controls and procedures addressing the quality and timeliness of disclosures, and to differentiate this concept of disclosure controls and procedures from the pre-existing concept of "internal controls" that pertains to controls over financial reporting. The SEC makes this distinction to effectuate Congress' intent¹—to have senior officers certify that required material non-financial information, as well as financial information, is included in an issuer's quarterly and annual reports. Accordingly, the disclosure controls and procedures should ensure timely

collection and evaluation of financial and non-financial information potentially subject to disclosure, which would include the capture of information that is relevant to an assessment of the need to disclose business risks and uncertainties.



As depicted above, there is a substantial overlap between a company's Section 302 disclosure controls and procedures and its Section 404 internal controls over financial reporting. However, there are some elements of disclosure controls and procedures that are beyond the scope of internal control over financial reporting.

Risk Management and Disclosure Controls and Procedures

The objective of an effective risk management process is to identify, prioritize, manage, and monitor risks associated with a company's business, including its business strategies, environmental conditions, regulations, and other risk factors. Companies that have implemented a comprehensive risk management process with effective coordination of risk functions are leveraging this process to identify risks and significant internal control changes that require disclosure in their periodic reports. On the other hand, companies operating with ineffective risk management processes face significant regulatory exposure associated with their inability to identify potential risks early, prior to the need to disclose certain risks and uncertainties or record related charges in the financial statements.

In an ideal situation, companies have an effective risk management process that enables them to identify potential risks early and allows them to foreshadow risk issues in their periodic resources well ahead of any specific financial reporting implications. With these new rules, companies can expect much more scrutiny of changes associated with risks that should have been foreseen and disclosed earlier in public filings. ✓

¹ U.S. Securities and Exchange Commission, *Final Rule: Certification of Disclosure in Companies' Quarterly and Annual Reports*.

Emerging Accounting Issues

Stock Options and Other Share-Based Payments

On March 31, 2004, the Financial Accounting Standards Board (FASB) issued its Exposure Draft *Share-Based Payment*, which is a proposed amendment to FASB Statement No. 123 *Accounting for Stock-Based Compensation*. Generally, the approach in the Exposure Draft (ED) is similar to the fair-value approach described in Statement 123. However, the ED would require all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values. Under Statement 123, the fair-value method was elective.

The FASB expects to issue a final standard in late 2004 that would be effective for public companies (and for non-public companies that currently use the fair value method, rather than the minimum value method, for recognition or disclosure purposes) for fiscal years beginning after December 15, 2004. Non-public companies that currently use the minimum value method for recognition or disclosure purposes would be required to adopt the new Statement in fiscal years beginning after December 15, 2005.

The Modified Grant-Date Approach

The ED utilizes a “modified grant-date” approach in which the fair value of an equity award is estimated on the grant date without regard to service or performance vesting conditions (this is consistent with Statement 123). That fair value is recognized (generally amortized as compensation expense) for all awards that vest. For awards that do not vest because employment or performance vesting conditions are not achieved, no compensation is recognized. The measure of compensation cost to be recognized over the service period can be expressed as the Price (i.e., fair value) of the award times the Quantity of the award ($P \times Q$). For equity awards, employment and performance vesting conditions do not impact “P,” but do impact “Q.” “Q” is adjusted as the estimate of the number of options that will vest changes. “P” is not adjusted for equity awards after the initial grant date measurement.

Another class of vesting or exercisability conditions is characterized in Statement 123 as “target stock price” conditions. Those conditions have been more appropriately characterized as “market” conditions in the ED. If exercisability is conditioned on the achievement of a specified stock price or return on the stock price (e.g., stock price appreciation plus dividends), that condition is incorporated into the grant date valuation of the award (“P”), not in determining the number of awards for which compensation is recognized (“Q”). That is, if the requisite service is provided, expense is recognized even if the target price is not achieved and the award is never exercisable.

Measurement of Share-Based Awards

The ED provides that equity instruments issued to employees generally should be measured and recognized based on the grant-date fair value of the equity instruments. While fair value may be readily determinable for awards of stock, market quotes are not available for long-term, nontransferable stock options because these instruments are not traded. Accordingly, the FASB believes that the fair value of a stock option awarded to an employee generally must be estimated using an option-pricing model, consistent with the requirements of Statement 123.

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PCAOB Overview

The Public Company Accounting Oversight Board (PCAOB) is a private-sector, non-profit corporation, created by the Sarbanes-Oxley Act of 2002, to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair, and independent

PCAOB Board Members	
William J. McDonough	Chairman, former Pres. & CEO of Federal Reserve Bank of New York
Kayla J. Gillan	former General Counsel to CalPERS
Daniel L. Goelzer	former General Counsel of the SEC
Bill Gradison	former nine-term Congressman (R-Ohio)
Charles D. Niemeier	former Chief Accountant, SEC Division of Enforcement

audit reports. This chart provides an overview of the PCAOB and issues that may be of interest to audit committees and management. More information is available on their Web site at www.pcaobus.org. ✓

Program/Leaders			
Registration/George H. Diacont	Standards/Douglas R. Carmichael	Inspection/George H. Diacont	Enforcement/Claudius B. Modesti
<p>Requirements</p> <ul style="list-style-type: none"> All auditors of public companies Registration deadline: Oct 22, 2003 for U.S. firms; extended to July 19, 2004 for non-U.S. firms (approved by the Board on March 25, 2004) <p>Information</p> <ul style="list-style-type: none"> Public audit clients and related fees Quality control processes and procedures Litigation and regulatory enforcement matters SEC filings disclosing accounting disagreements Roster of audit professionals Cooperation consents and registration certifications Developing requirements for annual updates of information <p>Fees</p> <ul style="list-style-type: none"> Public accounting firms pay fees to cover the PCAOB's costs of processing and reviewing their applications for registration SEC registrants pay accounting support fees that cover all other annual budgeted costs with amounts assessed based on market capitalization 	<p>Purview</p> <ul style="list-style-type: none"> Audit and related attestation standards Auditor independence/ethics standards and rules Firm quality control standards <p>Due Process</p> <ul style="list-style-type: none"> Board will establish standards Standing Advisory Group (SAG) has been established Proposals exposed for public comment Effective upon SEC approval <p>Status</p> <ul style="list-style-type: none"> Adopted primarily all existing AICPA standards as interim standards <p>Standards</p> <ul style="list-style-type: none"> Auditor's opinion must state that audit was conducted in accordance with standards of the PCAOB (Final, cleared by SEC) Audit of internal control over financial reporting <ul style="list-style-type: none"> Management applies a rigorous process, including documentation Auditor tests design and operating effectiveness Auditor communicates to audit committee all identified significant deficiencies and material weaknesses (Final, pending SEC clearance) Audit documentation <ul style="list-style-type: none"> Auditors must sufficiently document procedures performed, evidence obtained, and conclusions reached; retain document for seven years For multi-location audits, documentation performed at other locations, including those overseas, must be retained by or accessible to the office issuing the auditor's report (Final, pending SEC clearance) 	<p>Selection Criteria</p> <ul style="list-style-type: none"> Firm Level <ul style="list-style-type: none"> Large firms annually; others every three years Engagement Level <ul style="list-style-type: none"> Sample selected using risk-based approach <p>Current Areas of Emphasis</p> <ul style="list-style-type: none"> Firm Level <ul style="list-style-type: none"> Tone-at-the-top Risk Management Quality controls/audit methodologies Client acceptance/continuance processes Engagement Level <ul style="list-style-type: none"> Audit strategy and execution Significant accounting judgments Audit committee/auditor relationship Auditor independence Implementation of fraud audit standard (SAS 99) Sufficiency of audit work paper documentation Control of work referred to foreign affiliated firms <p>Rules</p> <ul style="list-style-type: none"> Oversight of non-U.S. accounting firms <ul style="list-style-type: none"> May rely on inspection and/or investigations of oversight systems in other jurisdictions; PCAOB may conduct its own investigations (Final, pending SEC clearance) <p>Inspection Findings</p> <ul style="list-style-type: none"> Profession – likely overall profession findings reported without firm attribution Firm – public reporting only if findings of deficiencies are not cured within 1 yr. 	<p>Philosophy</p> <ul style="list-style-type: none"> Speed: immediate investigations for apparent audit failures Fairness: right to defend actions Thoroughness: support for charges <p>Investigation</p> <ul style="list-style-type: none"> Emergency response team for potential audit failures Other investigations for potential violations discovered in PCAOB inspections or other regulatory activities <p>Discipline</p> <ul style="list-style-type: none"> Trial-like proceeding Range of sanctions <ul style="list-style-type: none"> Quality control and training measures Temporary or permanent ban on audit services for firm or individuals involved
Audit Committees/Company Considerations			
<ul style="list-style-type: none"> As applicable, follow developments relating to registration requirements of foreign audit firms Public accounting firms are required to seek waivers from SEC audit clients, including their foreign subsidiaries, to allow PCAOB and SEC access to auditor working papers and other information 	<ul style="list-style-type: none"> New audit obligations will likely increase the amount of audit work or audit documentation in future audits As a part of the audit of internal control over financial reporting, auditors will need to evaluate the effectiveness of audit committee oversight As new standards are promulgated, understand the effects on the audit 	<ul style="list-style-type: none"> Inspection procedures to include interviews with audit committee chairpersons 	<ul style="list-style-type: none"> Obtain more information from auditors as process develops Process may require reviewing public company's financial reporting as well as its auditor's work

Forward View

by Tapestry Networks



In Search of an ROI for Section 404

The latest cost estimate¹ of complying with Section 404 is just under \$2 million per company, or \$4.6 million for companies with over \$5 billion of revenue. It is hardly surprising that some boards of directors and their audit committees are considering whether what they had initially perceived as a “compliance tax” might instead be considered an investment—with a measurable return.

These companies believe that their Section 404 work will produce a return. One audit committee chair told us that he has asked all of the companies on whose boards he sits to keep good records on the costs, and to keep track of the sources of value in process reengineering and cost savings. However, he admitted that none of the companies has a precise framework for a return on investment (ROI) analysis.

So, where are the potential benefits likely to emerge? In our recent conversations with audit committee chairs, chief audit executives, and CEOs, we identified the following potential sources of value:

- As we reported in the March 2, 2004, edition of *InSights*, many CEOs view Section 404 as an “enabling vehicle” for process reengineering and have already tied internal controls work to “broader systemic process reforms” such as Six Sigma programs.
- Some companies have also reported an improvement in risk management. One executive told us that members of the corporation’s management team “... claim it was a useful process because it forced them to look at risks.”
- Other corporations are using Section 404 to help standardize global business processes. One chief audit executive referenced an investment in software that was not delivering ROI until the implementation of best practice standards identified for Section 404 compliance.

In a recent meeting of the Audit Committee Leadership Network (ACLN), members stated their belief that small-cap companies are gaining real value from the implementation of Section 404. Many of these companies are putting in place internal controls that should always have been there. Others are finding value in

what one member described as “reducing do-over work and manual routines in the finance function and controller’s office.” He added, “They will have made a wise investment.”

Some ACLN members felt that larger companies’ international subsidiaries will gain similar value. One audit committee chair commented, “The lesson for me is that some subsidiaries were not as well documented as they should have been.”

That said, many audit committee chairs with whom we have spoken do not believe there can be any return from what they characterize as a costly, “check the box” compliance activity. One audit committee chair commented that there was simply no point in calculating the ROI on Section 404 “since we have to do it anyway.” When asked about the value of Section 404, a chief audit executive for a *Fortune* 500 company replied, “In the end having the CEO and CFO able to sign the [financial] reports has to be enough.”

That also seems to be the view of the regulators. The SEC’s own cost/benefit analysis indicates that the ultimate benefit is “improving investor confidence in the reliability of a company’s financial disclosure and system of internal control over financial reporting. These benefits are not readily quantifiable.”

Even so, over the next few years many corporations will attempt to quantify their ROI for Section 404, if only to explain to shareholders what returns they might expect for their required ongoing investment.

Forward View is written by Tapestry Networks. Ernst & Young works with Tapestry Networks to orchestrate private dialogues, including the Audit Committee Leadership Network (ACLN), and develop practical insights and solutions to help enhance the functioning of financial markets. The ACLN is a group of audit committee chairs from some of America’s leading companies.

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¹ A January 2004 Financial Executives International (FEI) survey of 321 companies estimates the compliance costs for Section 404 will consist of 35,000 hours of internal manpower, \$1.3 million of external consulting and software, and additional audit fees of \$1.5 million for the largest companies in its sample.

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SCORE Retrieval File
No. CJ0003

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Emerging Accounting Issues: Stock Options and Other Share-Based Payments

The ED does not prescribe the use of a specific option-pricing model, but does require that companies use an option-pricing model that takes into account the following six inputs, at a minimum:

- The exercise price of the option
- The expected term of the option, taking into account both the contractual term of the option and the effects of employees' expected exercise and expected post-vesting termination behavior
- The current price of the underlying share
- The expected volatility of the price of the underlying share
- The expected dividends on the underlying share
- The risk-free interest rate(s) for the expected term of the option

Most companies have used the Black-Scholes-Merton formula to estimate the fair value of employee stock options for purposes of their pro forma disclosures or recognition in the income statement under Statement 123. However, the FASB concluded that the use of this formula or other "closed-form option pricing models" (i.e., formulas) that require the use of a single expected term as an input are not the best methods to estimate the fair value of an employee stock option. Because of the limitations of closed-form models such as the Black-Scholes-Merton formula, the FASB believes that a lattice model (e.g., a binomial model) is a preferable model to estimate the fair value of employee stock options.

The effort involved in performing a lattice calculation can be significant. Companies likely will have to collect and analyze significant amounts of employee exercise data to attempt to identify factors that are correlated to exercise prior to award expiration. As a practical matter, we believe many companies will not have the ability to develop the assumptions and perform the complex calculations without the assistance of valuation experts.

The conclusions in the FASB Exposure Draft are preliminary and subject to change. We will continue to keep you informed of the decisions reached by the FASB through various Ernst & Young publications and newsletters, Webcasts, and through our electronic portal Ernst & Young Online. This portal also contains our more detailed summary of the ED, along with a link to the FASB Web site where you can obtain a copy of the entire ED. You may also request a copy of our summary from your Ernst & Young partner or engagement team member. ✓

Looking Ahead

Here's a look at some of the topics under consideration for the next issue of *BoardMatters Quarterly*:

- The Changing Role of Internal Audit
- Outsourced Processes and SAS 70
- Managing Tax Risk
- Analyzing MD&A

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

Additional Resources

If you missed our recent Thought Center Webcast on Stock-Based Compensation or other relevant topics for audit committee members, go to eyonline.com/auditcommittee to watch a rebroadcast.

For more information, go to
eyonline.com/auditcommittee