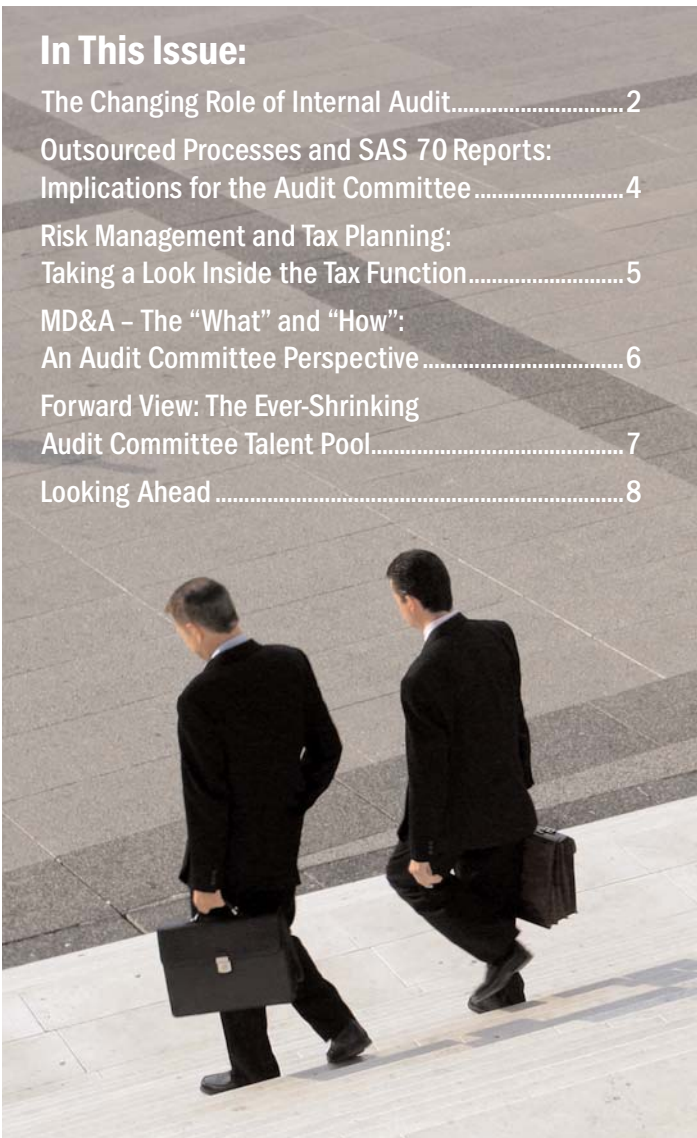


BoardMatters Quarterly

Critical Insights for Today's Audit Committee



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It has been more than two years since Congress passed the Sarbanes-Oxley Act of 2002, forever changing the role of the audit committee. As a result, audit committees have taken on a more active role with company management and the external auditor on corporate governance, risk management, and financial reporting issues. You now need more information than ever before to be effective in your role.

This issue of *BoardMatters Quarterly* features articles on several topics of interest to you and the other members of your board, including:

- The changing role of internal audit
- Outsourced processes and SAS 70 reports
- Risk management and tax planning
- The “what” and “how” of MD&A
- The audit committee talent pool

Ernst & Young recently conducted two Section 404-related Thought Center Webcasts. The first—A Practical Approach to 404—drew more than 4,500 viewers. The second focused on IT issues. If you were unable to participate, please go to www.ey.com/webcast to watch a rebroadcast.

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. ✓

The Changing Role of Internal



The demands on the internal auditor are changing as companies strive to enhance governance, manage their risk more effectively, and create a sustainable Sarbanes-Oxley compliance process. The Chief Audit Executive, in particular, is in the corporate spotlight much more frequently. For the internal audit team, the current environment presents a unique set of challenges, as well as an exciting opportunity to contribute to the organizational agenda and add real value.

To succeed in this environment, internal audit may have to change old staffing models and more effectively navigate the often-conflicting expectations of its stakeholders.

The New World Order

Until recently, internal audit's focus had been moving away from financial control towards addressing a wider spectrum of risk within the organization and, in particular, on the efficiency and effectiveness of operational processes. However, recent regulatory changes have caused internal auditors to reorient their work. Indeed, internal audit is increasingly being asked to provide broad and deep support of the company's ongoing Sarbanes-Oxley Section 404 process. Just as internal audit returns to financial controls, audit committees are looking at ways to better discharge their responsibilities for overseeing the company's management of its business risks as a whole.

The Challenges

What are the specific challenges facing internal audit functions today?

- In order to be able to support management's internal control assessment, internal auditors need to bolster their financial control skills. Internal audit departments must invest in training their teams in techniques to document transaction processes, identify financial statement risks, and evaluate the effectiveness of controls over financial reporting. Some internal audit departments are beginning to struggle with the human resource implications of this new focus. Not all auditors are interested in focusing their work in the area of controls compliance. To address this, some departments are building new separate compliance groups within their function. Others have teamed up with accounting firms to help them meet the demands of Sarbanes-Oxley.

Audit



- Internal audit functions may struggle to maintain an adequate IT audit capability. In many organizations, the IT control environment has been management's greatest challenge. IT general controls and application controls are often not robust and there is a lack of audit specialists in this area. Companies are devoting considerable resources to correcting and enhancing manual controls around the IT system to meet the deadline of first year compliance with Sarbanes-Oxley, but are considering a longer-term investment in core systems to achieve more efficient and effective financial control in future years. Internal audit must add additional resources with IT audit skills, particularly associated with Enterprise Resource Planning (ERP) systems, to help management ensure that these systems are effectively controlled after they are implemented.
- Companies will need to involve their internal audit teams in programs to sustain and embed Section 302 and 404 compliance processes into the fabric of the business beyond the first year of compliance. In examining options, management should balance the cost of compliance with potential benefits. This has generated renewed interest in control self-assessment techniques and technology-based solutions that can maximize the extent of controls testing for relatively minimal cost. Internal audit is being called upon to provide thought leadership and advice in these areas.
- Internal audit will need to become more involved in strategic areas of the business and in corporate governance. Stock exchange listing rules now require audit committees to oversee risk management more explicitly. The new COSO standard on risk management focuses not only on operational, compliance, and financial controls, but also on how companies should address strategic risk such as the risk associated with major business decisions. In many companies, the only formal risk assessment process is that performed by the internal auditors who have developed skills in risk assessment and risk reporting. Internal audit will likely play a key role in helping the board understand and consider business risk, and assess how well management is dealing with risk.

Realizing the Challenges

The scope of internal audit has expanded to help management meet regulatory deadlines. Even the largest audit departments are being stretched to meet the challenges of their new role. Internal audit departments are responding by hiring additional staff and

adapting their capabilities through training—but this may not match the pace required by the changing environment. There is now greater demand than ever for audit teams to supplement core competencies with more specialist skills.

Many departments are seeking innovative and flexible arrangements with outside providers to ensure they can provide the right person with the appropriate skill sets, at the right time and in the right place.

Management cannot afford to under-invest in internal audit. Audit committees, the board, and management must critically evaluate internal audit's role, its capabilities, and resources to be confident that they can truly deliver value in the new world order. ✓

Key Questions to Ask When Considering Your Internal Audit Capability

1. Are you satisfied that internal audit has the financial audit skills base to meet today's challenges?
2. How does internal audit keep current and trained to be effective? Are they investing to overcome expected future challenges?
3. Should internal audit have a separate compliance team to address on-going compliance with Section 404?
4. Can the IT audit team support the challenges of the IT control environment?
5. Are internal audit and your other risk functions working to leverage the Sarbanes-Oxley compliance process?
6. Do the Sarbanes-Oxley compliance tools you are using enable the assessment of the broader control environment outside financial reporting?
7. Does internal audit help meet your responsibilities for company-wide risk management?
8. Can internal audit adapt to your changing environment and deploy the right people with the right skills to match your call to action?

Outsourced Processes and SAS 70 Reports

Implications for the Audit Committee

What is SAS 70?

Statement on Auditing Standards (SAS) No. 70, *Reports on the Processing of Transactions by Service Organizations*, is an auditing standard developed by the American Institute of Certified Public Accountants (AICPA). Completed by an independent audit firm, a SAS 70 examination is widely recognized because it provides information on a service organization's control activities, including the internal control policies and procedures and their effectiveness.

In the final stages of Section 404 readiness, companies are deeply focused on the internal controls of the processes management relies on for their financial statements. While many of these processes are in-house functions, other processes such as payroll, accounts receivable, or cash management may be outsourced to external service organizations. For these outsourced processes, management is responsible for determining that the internal controls within the process are properly designed and operating effectively, either through their own controls (e.g., basic banking activity or transfer agent) or through reliance on the service organization's controls. However, management's responsibility only extends to outsourced activity that affects the initiation, authorization, recording, processing, or reporting of transactions in the financial statements (i.e., the services that are part of the company's information system).

For situations where management places reliances on the service organization's controls, and therefore needs to evaluate their effectiveness, management may decide to directly perform tests of controls at the service organization. However, a more widely used approach is to obtain a Statement on Auditing Standards No. 70 (SAS 70) audit report. While SAS 70s have become a critical source of Section 404 compliance, both company management and audit committees need to understand their benefits and potential incompatibilities.

Quality

Although it is not generally necessary for the audit firm conducting the SAS 70 to be registered with the Public Company Accounting Oversight Board (PCAOB), it is important that the audit firm has the appropriate competencies and experience level to provide your company with a high-quality report that satisfies your documentation needs. Your auditor may also be your service organization's SAS 70 auditor. In most circumstances, this is acceptable. However, the auditor, management, and audit committee should discuss any potential independence issues in this situation.

Scope

SAS 70 was developed as an auditor-to-auditor assessment report. Today, Section 404 has produced the need for management's involvement in this assessment to make certain the report aligns with the company's documentation and testing strategy. Understanding the scope of the report will help management eliminate potential gaps in documentation and testing, and reduce the need for additional work to address internal controls not covered in the SAS 70. It is also common to find service organizations outsourcing select processes to other service organizations.

Management's understanding of the inherent risks in these relationships, some of which may be off-shore relationships, is critical to the company's Section 404 efforts.

Timing

The period of time covered by the SAS 70 can affect the usability of the report. The AICPA recommends a SAS 70 report cover at least a six-month period, but also recognizes that circumstances may necessitate a shorter testing period; alternatively, you and your auditor may prefer a report that covers a nine-to-twelve month period. In addition, you will want the review period to be as close to the date of management's Section 404 assessment of internal control. Any significant gap in the timing could require additional work to ensure the effectiveness of the service organization's internal controls as of the date of management's assessment.

Timing is also a factor with SAS 70 reports that contain a qualified opinion. Management and your auditor must determine the effect on your company's Section 404 compliance. The sooner this information is issued, the more time your company has to react.

Compliance

Section 404 compliance activities are motivating more service organizations to provide SAS 70 reports. Yet, SAS 70 is not a required report, and for situations where SAS 70 reports have not been built into the service contract, service organizations may choose alternative documentation. Auditor and management discussions will need to determine the reliability of the alternative documentation. If necessary, the company and auditor may need to take additional steps, including on-site visits.

Overall, addressing any key considerations requires ongoing communication with the external auditor, management, and the service organization. Through active dialogue, management will be able to apply proper vendor management control and give assurance to audit committee members that the internal controls within the company's outsourced processes are effective. ✓

QUESTIONS FOR MANAGEMENT

- Are you sufficiently monitoring internal controls within outsourced processes? Are you relying on the service organization's controls or your own?
- If the service organization providing the outsourced process is issuing a SAS 70 report, how does it fit into your 404 compliance strategy (i.e., scope, timeframe, auditor opinion, credentials, user controls)?
- If SAS 70 is not used, what actions are you taking to gain comfort over the service provider's controls?

Risk Management and Tax Planning

Taking a Look Inside the Tax Function



Tax departments have successfully met the challenges posed by the cost management-driven agendas of the 1980s and the value-oriented agendas of the 1990s. Now, they also must meet significantly heightened risk management challenges to satisfy intensifying transparency, corporate governance, and other environmental demands. And, these challenges must be successfully met in a balanced manner. The stakes are mounting, both from financial and reputation standpoints, due to intense scrutiny by tax enforcement agencies, heightened attention from the legislators, politicians, and the media, and greater focus from a wide range of corporate stakeholders.

Tax departments must meet these challenges in an increasingly complicated business and tax world. Workloads are rising as well as the level of complexity. Yet many tax departments will not receive additional resources. They are examining their priorities and corresponding strategies and tactics, and making appropriate adjustments that allow them to tighten their tax department processes, better allocate resources, and sustain high performance.

A model set of strategic priorities for the tax department is emerging:

- Risk management is a predominant driver
- Tax planning remains a priority
- Communication is a core value
- Superior execution is a commitment
- Business alignment is imperative

A Closer Look at Risk Management and Tax Planning

All five priorities are important. Transparency demands and the increasing population of different stakeholders now interested in the tax situation require tax departments to excel at communication. The premium placed on the quality of processes and documentation requires an unparalleled commitment to superior execution. More effective alignment to business units, personnel, and processes is a must to enable superior execution. However, the most strategic imperatives are world-class risk management and effective tax planning.

Risk Management

Environmental factors have positioned tax risk management as the driving imperative. Now, tax department decisions can become the subject of intense market, regulatory, and media scrutiny.

SEC TAX FOCUS AREAS

- Accounting for, and disclosure of, income tax provisions, including tax exposure items
- Call for increased communications with audit committees regarding tax matters
- Appropriate tax documentation to support positions
- Sufficient disclosure and transparency in footnotes and MD&A
- Valid business purpose and economic substance met on tax benefits

Corporate stakeholders are discovering that tax decisions can have a direct impact on their ability to preserve both enterprise value and reputation. Internal and external stakeholders are beginning to focus on tax matters and on the methods and processes for managing tax risk.

As a result, in today's Sarbanes-Oxley era, the tax function is coming to be viewed much like other major functional areas in the organization. Like IT, finance/treasury, regulatory/compliance, operations, and transactions, tax should be considered one of the major components of organizational risk—it must be *protected* from potential risk consequences, just as other functional areas have been. And that means, very often, that an organization must have a comprehensive tax risk process. Correspondingly, a tax department must be able to demonstrate to all stakeholders that comprehensive risk management processes are in fact working, and it must effectively communicate with stakeholders, critical among them the audit committee.

The definition of tax risk is transforming into a more comprehensive concept due to the changing environment and should encompass technical risk (are exposure items covered?), operational risk (are tax department processes in place mitigating risk?), as well as a very new point of view: *tax opportunity risk* (is the organization potentially overreacting and unwinding or forgoing viable tax opportunities?).

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MD&A – The “What” and “How”

An Audit Committee Perspective

Management’s Discussion and Analysis (MD&A) has received a lot of attention from the SEC lately. Audit committees should be aware of the SEC’s heightened focus and its latest pronouncements when reviewing the company’s SEC filings and MD&A.

Hoping that companies would significantly improve the quality of their MD&A, the SEC issued FR 72, *Interpretation: Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operation*, in December 2003.

FR 72 reminds companies about MD&A’s three principal objectives:

- To provide a narrative explanation of a company’s financial statements that enables investors to see the company through the eyes of management
- To enhance the overall financial disclosure and provide the context within which financial information should be analyzed
- To provide information about the quality of, and potential variability of, a company’s earnings and cash flow, so that investors can ascertain the likelihood that past performance is indicative of future performance

In reviewing MD&A, audit committee members should challenge whether the company has achieved all three of these objectives.

FR 72 offers the following suggestions to improve the quality and usefulness of MD&A:

- **Overall Presentation of MD&A** – Management needs to take a fresh look at MD&A. Over time, the presentation of the MD&A often has become unnecessarily lengthy and confusing.



At a minimum, FR 72 challenges companies to avoid boilerplate and not merely repeat disclosures from prior filings. At the extreme, FR 72 essentially encourages companies to rewrite MD&A starting with a blank sheet of paper. In either case, FR 72 recommends the early involvement of top-level management.

- **Focus and Content of MD&A** – MD&A should incorporate the key indicators used by management to assess financial condition and operating performance. The SEC also encourages companies to limit MD&A disclosures to material information and to emphasize the more material information. The SEC believes that most companies could provide better analysis of the implications and significance of matters disclosed within MD&A.
- **Liquidity and Capital Resources** – MD&A disclosures about liquidity and capital resources often fail to clearly analyze and explain a company’s sources and uses of cash. MD&A rules require the company to discuss its ability to meet upcoming cash requirements, over both the short- and long-term. Companies also must discuss the implications of any material trends or uncertainties related to their future cash requirements or their sources of liquidity or capital.
- **Critical Accounting Estimates** – Companies should consider providing enhanced disclosure and analysis of their critical accounting estimates and assumptions. Such disclosures should (1) supplement, but not duplicate, the description of the accounting policies included in the footnotes to the company’s financial statements, and (2) provide greater insight into the quality and variability of amounts presented in the financial statements.

Relevance to Audit Committees

The SEC staff has indicated that MD&A will receive particular attention in its expanded reviews of public company reports. Companies can expect SEC comment letters to question MD&A compliance and suggest remedial or prospective changes. In addition, if the overall quality of MD&A does not improve, allowing the guidance of FR 72, the SEC staff has indicated that it will recommend that the SEC undertake additional MD&A rulemaking.

Although management has the primary responsibility for MD&A, audit committees should challenge how management is responding to the recommendations of FR 72 and the SEC’s heightened focus and expectations for MD&A. The audit committee also should ensure that the company’s risk management processes allow for any potential risks to be foreshadowed in MD&A well ahead of any specific financial reporting implications. ✓



The Ever-Shrinking Audit Committee Talent Pool

More and more CEOs are beginning to review their commitments to serving on other company's boards of directors, highlighting the latest trend in corporate governance: when it comes to board memberships, less is more. Former SEC Chairman and MCI Corporate Monitor Richard Breeden recommended that a sitting CEO should limit his or her board membership to just one company. He is obviously not alone.

Conventional governance wisdom in the U.S. and Europe states that the fewer boards a director sits on, the better it is for the shareholders of the companies on which they do sit. This approach raises intriguing questions about the possible temptations of directors having more time to encroach upon operational management. But in our recent discussions with audit committee chairs in North America, we have heard that the main, unintended consequence for audit committees may well be the draining of the required talent pool.

If current directors sit on fewer boards and then either refuse to serve on the audit committee, or are deemed not qualified to do so, the talent pool will be in danger of becoming a talent puddle. There are many reasons why this might come to pass:

- Institutional Shareholder Services (ISS) recommends withholding votes from directors who sit on more than six boards. Their 2004 policy statement says, "Recent surveys of directors also confirm a desire for limiting board memberships, generally to three to five seats. In view of the increased demands placed on board members, ISS believes that directors who are overextended may be jeopardizing their ability to serve as effective representatives of shareholders."
- Governance experts also recommend limiting board memberships. The August 2003 Breeden report¹ for MCI envisions directors spending more time on a single board's business, but being compensated at much higher levels to do so (for example, MCI directors can only serve on two other public company boards).
- Some governance committees require directors to step down from a number of boards and audit committees and to limit the number of audit committees on which a director can sit to three, in line with NYSE rules.

- Some directors are refusing to sit on the audit committee at all. They report that expectations of the amount of work they ought to do have changed significantly. There is also a perception of personal financial and reputational risk.

Of course, one solution would be to increase the supply of candidates for board membership. When asked what background they would choose in a new audit committee member, Spencer Stuart reported that 52% of companies would choose a CFO background, an increase of one-third over 2002². CEO talent, which currently makes up almost half of audit committee members³, is becoming scarce. How soon will it be before we see similar pressures to limit board memberships being exerted on their CFO colleagues?

The executive search firms' Web sites indicate their confidence that there are still some unexplored talent pools below the level of CEO, CFO, and COO. However, these candidates likely lack both board and audit committee experience.

It will take time to tap into fresh sources of talent and provide opportunities to gain audit committee experience. Meanwhile, limiting the number of boards and audit committees on which experienced directors can sit may well benefit the largest companies who can retain them, but it also reduces the supply of experienced directors available to other mid- and small-cap companies.

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 "Restoring Trust," Report to The Hon. Jed S. Rakoff, The United States District Court for the Southern District of New York On Corporate Governance for the Future of MCI, August 2003

² Spencer Stuart Board Index: Trends in S&P 500 boards, 2003, <http://www.spencerstuart.com/ArticleViewer.aspx?PageID=10096&ArtID=4074787>

³ *ibid*

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Risk Management and Tax Planning: Taking a Look Inside the Tax Function

Tax Planning

Within the context of sound risk management, tax planning should remain a priority. The tax profile of a multi-national enterprise is a complex concept resulting from the operation of the enterprise's business processes and attributes in many jurisdictions and across many borders. The entire array of taxes imposed on a global enterprise by a myriad of jurisdictions is daunting and financially significant. The tax department, aligned to the business units and supported by management, must be ever watchful that the global tax burden is not excessive, given the overlying global business situation.

The Audit Committee, Management, and the Tax Department

Thorough and frequent communication between the tax function, audit committee, and senior management are critical. With open communication and an environment of cooperation, tax department leaders can leverage the risk management and business experience of the audit committee and better deploy processes to drive the priorities. At the same time, audit committees can remain informed on critical financial and reputation-related tax items and be prepared to address the rising priority of tax matters.

Today's environment poses new challenges and opportunities for tax departments. The financial and reputation stakes riding on tax risk management are high and stakeholders' expectations are increasing. In this challenging environment, surprises can be avoided, reputations can be protected, and value can still be derived through appropriate tax planning and risk management. ✓

Looking Ahead

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

- Reporting Implications for 404
- Section 404 Reporting Matters

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 Thought Center Webcasts on *The FASB's Proposed Amendment to Statement No. 123: Share-Based Compensation, Stock Options: Out of the Footnotes and Onto the Front Page, A Practical Approach to 404, 404: IT Issues That Really Matter*, or other relevant topics for audit committee members, go to ey.com/webcast to watch a rebroadcast.

**For more information, go to
eyonline.com/auditcommittee**