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Critical Insights for Today's Audit Committee

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As we head into a new year, management and the audit committee must now work together to move the company's Section 404 initiatives from special project status to an ongoing program. For many companies, year one has been a consuming effort of documenting significant processes, testing and evaluating the effectiveness of controls, and remediating control deficiencies. Beginning in year two, you must develop a sustainable framework for the future.

Section 404 is here to stay—it is vital that companies establish ongoing processes and programs to manage internal controls while extracting value from the company's efforts in year one. You need to begin thinking about and focusing on the future state of Section 404 compliance *now*.

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

- Section 404: evaluating control deficiencies
- Key considerations for your 2004 year-end financial report
- Reporting considerations after management's first Section 404 report
- Understanding the 2004 Tax Act
- Audit committees and the war on terror

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. ✔

Section 404: Evaluating Control

The number of internal control deficiencies identified by public companies has increased significantly in recent months largely in response to the testing and evaluation of controls to comply with Section 404. For control deficiencies not remediated before year-end, a key challenge for management is to appropriately evaluate the severity of the deficiency and to determine whether the deficiency is believed to be a significant deficiency or material weakness. Audit committee members should be aware of the key concepts that factor into the evaluation of deficiencies.

Recently, a framework[1] was published to assist public companies and their auditors with the process of evaluating process/transaction level control deficiencies. Developed by nine public accounting firms, including Ernst & Young, and a professor from Georgia State University, the suggested framework reflects the views of its developers, and it includes a thought process that requires significant judgment. Below are a few highlights from the framework for evaluating process/transaction level control deficiencies and other observations about evaluating those deficiencies.

Determining Whether a Significant Deficiency Exists

When evaluating the severity of a control deficiency, the framework recognizes the requirement to consider both the *likelihood* of a potential misstatement and the potential *magnitude* of a misstatement that could result from the deficiency. It also recognizes that PCAOB Auditing Standard No. 2 states that the risk of misstatement might be different for the maximum possible misstatement than for lesser possible amounts, and that the evaluation of deficiencies requires both quantitative and qualitative considerations.

A *significant deficiency* is defined as a control deficiency, or combination of control deficiencies, that adversely affects the company's ability to initiate, authorize, record, process, or report external financial data reliably in accordance with generally accepted accounting principles such that there is *more than a remote* likelihood that a misstatement of the company's annual or interim financial statements that is *more than inconsequential* will not be prevented or detected.

When evaluating whether a control deficiency is a significant deficiency, key questions to consider include:

- ***Is the magnitude of a potential misstatement inconsequential?***

  Consider the magnitude of a potential misstatement to annual or interim financial statements that may be caused as a result of the control deficiency. If the potential magnitude is estimated to be inconsequential (considering both quantitative and qualitative factors), the deficient control generally would be classified as only a control deficiency. Although the Section 404 assessment is performed as of the end of the company's fiscal year, the assessment includes controls relevant to both annual and interim financial reporting. Therefore, the evaluation of deficiencies should consider the potential for misstatements to either annual or interim financial statements.

- ***Are there other controls, such as redundant controls, that were tested and evaluated that achieve the same control objective?***

  Even if a deficient control is identified, there may be redundant controls that achieve the same control objective. If these other controls exist and have been tested and evaluated as effective, the deficient control identified generally would be classified as only a control deficiency.

- ***Are there compensating controls that were tested and evaluated that reduce the magnitude of a potential mis-statement to inconsequential?***

  Although redundant controls may not be present, compensating controls could exist that prevent a deficiency from being classified as a significant deficiency. In this case, compensating controls need to operate at a level of precision that would prevent or detect a more than inconsequential misstatement of annual or interim financial statements.

In all circumstances, the views of a prudent official[2] should be considered before reaching a final conclusion as to whether a significant deficiency exists. In other words, on a qualitative basis, consider if a third-party prudent official would be satisfied that at least a significant deficiency does not exist based upon the facts and circumstances.

Deficiencies

Determining Whether a Material Weakness Exists

A *material weakness* is defined as a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

When evaluating whether a significant deficiency is a material weakness, key questions to consider include:

- ***Is the magnitude of a potential misstatement less than material?***

  Consider the magnitude of a potential misstatement to annual or interim financial statements that may be caused as a result of the significant deficiency. If the potential magnitude is less than material (considering both quantitative and qualitative factors), then the deficient control generally would be classified as a significant deficiency rather than a material weakness.

- ***Are there compensating controls that were tested and evaluated that reduce the magnitude of a potential misstatement to less than material?***

  Compensating controls that operate at a level of precision that would result in the prevention or detection of a *material* misstatement of annual or interim financial statements may support a conclusion that the deficiency is not a material weakness.

The framework also mentions that, even though answers to the questions above might suggest a material weakness exists, additional evaluation could result in a judgment that the likelihood of a material misstatement is remote (and, therefore, a conclusion could be reached that a material weakness does not in fact exist). Examples of factors to consider in the additional evaluation include the nature of the financial statement accounts, disclosures and assertions involved, the susceptibility of the related assets or liabilities to loss or fraud, the possible future consequences of the deficiency, and certain other factors. However, after concluding that the magnitude of a potential misstatement is material and no compensating controls exist, we believe that it would be rare for additional evaluation to support a conclusion that a material weakness does not exist.

In all circumstances, the views of a prudent official should be considered before reaching a final conclusion as to whether a material weakness exists. On a qualitative basis, consider if a third-party prudent official would be satisfied that a material weakness does not exist based upon the facts and circumstances.

Consider the Effects of Aggregating Deficiencies

In addition to focusing on the evaluation of individual control deficiencies, the effects of aggregating more than one deficiency needs to be considered. The combination of several deficiencies affecting the same significant account or disclosure (for process/transaction level controls) or the same COSO component (for entity level controls) could aggregate to a more severe deficiency (i.e., grouping individual deficiencies and significant deficiencies could result in a material weakness in the aggregate). All deficiencies, not just significant deficiencies, should be considered when evaluating whether a material weakness exists in the aggregate. ✔

Key Questions to Consider

1. When evaluating whether a control deficiency is a significant deficiency:
   - Is the magnitude of a potential misstatement inconsequential?
   - Are there other controls, such as redundant controls, that were tested and evaluated that achieve the same control objective?
   - Are there compensating controls that were tested and evaluated that reduce the magnitude of a potential misstatement to inconsequential?
   - Would a prudent official view the control deficiency as a significant deficiency?
2. When evaluating whether a significant deficiency is a material weakness:
   - Is the magnitude of a potential misstatement less than material?
   - Are there compensating controls that were tested and evaluated that reduce the magnitude of a potential misstatement to less than material?
   - Does additional evaluation result in a judgment that the likelihood of a material misstatement is remote?
   - Would a prudent official view the significant deficiency as a material weakness?

1 The evaluation framework is intended to be read in its entirety and used in conjunction with the guidance in PCAOB Auditing Standard No. 2. A copy of the entire framework can be accessed at www.eyonline.com/auditcommittee (click on the Other Resources tab at the top of the screen).

2 The prudent official concept is described in PCAOB Auditing Standard No. 2 and SEC Staff Accounting Bulletin Topic 1M2.

IMPORTANT: On November 30, 2004, the Securities and Exchange Commission issued an exemptive order to grant certain accelerated filers up to an additional 45 days to file their Section 404 management and independent auditor reports on internal control over financial reporting. All other information required in annual reports, including audited financial statements, would have to be filed on the original due date (75 days after year end) for the annual reports. The exemptive order applies to an accelerated filer that has a fiscal year ending between and including November 15, 2004, and February 28, 2005, and that had a public equity float of less than $700 million at the end of its second fiscal quarter in 2004.

What's Changed?

Key Considerations for Your 2004 Year-End Financial Report

The 2004 year-end financial statement close will break new ground because of the additional workload involved with completing the Section 404 assessment. But, don't lose sight of the big picture—getting the financial statements right. At a high level, companies need to develop a plan, execute and stay focused on both Section 404 and the financial statements, and monitor progress through completion.

Develop a Plan

If you have not started already, here are some things to consider as you develop the plan:

- *Perform a Section 404 status check and anticipate key challenges* – Identify where you are in the Section 404 assessment, address immediate problems, and anticipate the key challenges you'll need to overcome.
- *Review key meeting and reporting dates* – Take a realistic look at the calendar and challenge if key dates are still viable given the additional workload.
- *Anticipate if "Plan B" is needed* – Consider the possibility that you won't meet your objectives, such as if you identify a material weakness that cannot be remediated before year-end. Anticipate any resulting communications and disclosures that will be needed.

Execute and Stay Focused

Once the plan is in place, remember to focus on both objectives—assessing the effectiveness of internal controls and preparing the financial statements and annual report disclosures.

Section 404 Internal Control Assessment

- *If there are unresolved scope questions, resolve them now!* Take action to address any open questions relating to the scope and coverage of the 404 assessment.
- *Finalize interim testing and update work through year-end* – The interim assessment should now transition to the year-end assessment date when management will express its assertion on the effectiveness of internal controls.
- *Consider the effects of proposed audit adjustments* – If your external auditor proposes adjustments to the financial statements, identify and evaluate the underlying control deficiencies that caused the adjustments.
- *Test the financial statement close process, including controls over disclosures* – The assessment should include the testing and evaluation of controls relating to both the annual and quarterly financial statement close process, including controls over the preparation of footnote disclosures included in the Form 10-K.
- *Evaluate identified deficiencies, both individually and in the aggregate* – It is important to have a process in place to consistently evaluate the severity of the deficiencies and to determine if a material weakness is present.
- *Prioritize and remediate higher-risk deficiencies before year-end* – Prioritize and remediate before year-end the higher-risk control deficiencies that could potentially be characterized as a material weakness.
- *Proactively communicate with the audit committee and the external auditor* – Management should keep the audit committee and the external auditor in the loop and establish communication protocols for control deficiencies that may be identified.

Financial Statements and Annual Report Disclosures

- *Don't cut out the external auditor, but establish the right working protocols* – The auditor may continue to work with management in many respects, but some aspects of the traditional process of working with the auditor will need to change. Establish working protocols to avoid potential issues in situations where management effectively has relied on the external auditor as a control when preparing financial statements and disclosures.
- *Begin drafting your annual report* – Start thinking about the changes you will need to make this year. For instance, begin drafting new internal control disclosures that will be needed in Item 9A of Form 10-K.

Monitor Your Progress Until Completion

Stay flexible. The work required to complete Section 404 internal control assessments has significantly exceeded initial estimates, and you should expect that additional unforeseen time and cost may be incurred if deficiencies are identified or other obstacles are encountered.

As you complete your Section 404 work, stay focused and don't take the 2004 annual financial statement close for granted. It is important to get the financial statements right, despite the increased effort caused by Section 404. ✔

For more detailed information, including key questions to ask your team during this process, contact your Ernst & Young client service partner to request a copy of our recent publication on this topic, What's Changed? Key Considerations for Your 2004 Year-End Financial Report. *It is also available on-line at* www.eyonline.com/auditcommitee *under the E&Y Publications tab.*

Reporting Considerations After Management's First Section 404 Report

Management and audit committees should begin planning for those SEC rules and Public Company Accounting Oversight Board (PCAOB) standards that become effective in quarterly reports following the registrant's first annual report that includes management's Section 404 report. Specifically, the standard language in the Section 302 certification will change and management and audit committees should be aware that the auditor now will be required to perform limited procedures each quarter involving the registrant's disclosures about material changes in internal control over financial reporting.

Registrants must file a management certification called for by Section 302 of the Sarbanes-Oxley Act of 2002 (the Act) as Exhibit 31 to their periodic reports (i.e., Form 10-Q and Form 10-K). Following the registrant's first annual report that includes management's Section 404 report, the Section 302 certification must include certain language that was previously optional. Similar to management's Section 404 report, management now must certify that they are responsible for establishing and maintaining internal control over financial reporting, and that they have designed internal control over financial reporting to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with GAAP.

Pursuant to Item 308(c) of Regulation S-K, the registrant must disclose in each quarterly report any change in internal control over financial reporting that occurred during the registrant's last fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting. As clarified by the SEC staff's related frequently asked questions document, this would encompass disclosing a change (including an improvement) to internal control over financial reporting that was not necessarily in response to an identified significant deficiency or material weakness (e.g., the implementation of a new information system). In addition, following the registrant's first annual report that includes management's Section 404 report, SEC regulations specifically require management, with the participation of the CEO and CFO, to *evaluate* such material changes in internal control on a quarterly basis.

While the quarterly evaluation related to internal control over financial reporting is not as extensive as that required at each fiscal year end, the quarterly evaluation may identify significant deficiencies or material weaknesses in internal control over financial reporting, which must be disclosed to the audit committee and the independent auditor, and which could have additional public disclosure implications.

The Section 302 certification also requires management to certify that they have disclosed in the periodic report any material changes in internal control over financial reporting. Furthermore, in each quarter following the auditor's first audit report on the registrant's internal control over financial reporting, PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed In Conjunction With An Audit Of Financial Statements*, requires the auditor to perform limited procedures to provide a basis for determining whether he or she has become aware of any material modifications that, in his or her judgment, should be made to the Item 308(c) disclosures in order for management's Section 302 certification to be accurate and to comply with the requirements of the Act. The limited procedures principally will consist of:

- Inquiring of management about significant changes in the design or operation of internal control over financial reporting
- Evaluating the implications of any misstatements the auditor identifies as part of the SAS 100 review of interim financial information as it relates to effective internal control over financial reporting
- Determining, through observation and inquiry, whether any change in internal control over financial reporting has materially affected, or is reasonably likely to materially affect, the company's internal control over financial reporting

When the auditor becomes aware of matters that lead him or her to believe that modification to the Item 308(c) disclosures is necessary, the auditor will communicate the matter to the appropriate level of management as soon as practicable. If, in the auditor's judgment, management does not respond appropriately to the communication within a reasonable period of time, the auditor will inform the audit committee.

If the audit committee receives such a communication, it should respond immediately because if, in the auditor's judgment, the audit committee does not respond within a reasonable period of time, PCAOB Standard No. 2 indicates the auditor should evaluate whether to resign from the engagement.

In light of these changes, the registrant should ensure that it has a process in place to identify, evaluate, and disclose all material changes in internal control over financial reporting each quarter. In addition, audit committees should anticipate increased communication with management and the auditor each quarter regarding changes in internal control over financial reporting. ✔

Understanding the 2004 Tax Act

While the American Jobs Creation Act of 2004 provides opportunities for many companies to save taxes, it also imposes severe penalties—including mandatory disclosures in SEC filings—for failing to fulfill certain new obligations. Management is now shifting its emphasis from learning about the new law to understanding the specific implications for the company. With an increased focus on corporate behavior, generally, and tax risk management, specifically, boards, audit committees, and corporate tax executives need to work together to avoid foot-faults—especially where board ratification is required.

This article provides an overview of where management should consider directing time and resources based on your company's particular circumstances. Discussed below are some of the more high profile and significant provisions under the new law in terms of their implications for financial reporting, business processes, and other business considerations. Audit committees also need to be aware of these provisions.

New Deduction for Domestic Production Activities and Elimination of Export Tax Incentive

The new law creates a special "production deduction" for companies engaged in a broad range of qualifying activities, even those not normally thought of as conventional manufacturing. For example, companies that produce electricity and construct buildings in the U.S. may qualify. Although the new law replaces an export tax incentive (commonly referred to as "ETI") that has been in place for many years, companies can qualify for the production deduction even if they don't export.

Implications and Considerations

For companies that qualify, the new deduction may provide significant tax, cash flow, and financial statement benefits. Boards should work closely with management regarding matters such as aligning the company's business operations to realize the optimum benefit of the new deduction, including making modifications to operations or to supply chains. Furthermore, inquiry should be made regarding system and process changes that may be required to capture financial and other data needed to document the deduction.

Boards should ensure that management is taking a comprehensive approach to both the new production deduction and the repeal of the export incentive (ETI) which will be completely phased out by 2007. That means management should be properly considering the combined effects on operations, financials, and taxes if a company both qualifies for the new production deduction and has been a beneficiary of ETI.

One-time Earnings Repatriation Incentive

The new law allows certain companies to bring back to the U.S. foreign earnings at a 5.25% rate during a small window of opportunity.

Implications and Considerations

To claim the low 5.25% rate, repatriated earnings must be reinvested in the U.S. under a plan approved by the board. Boards, with senior management participation, need to study the company's overall cash and tax management strategies. Like the new deduction for domestic production and the phase out of the export incentive, repatriation has unique financial statement implications such as the impact of unrecorded deferred taxes.

Some of these considerations will need to be addressed by accounting rules makers, specifically the Financial Accounting Standards Board, which has issued draft guidance on financial statement and disclosure issues. Management should be closely working now with staffs from the tax, treasury, and cash management functions to develop an integrated approach for analyzing the benefits and costs of the short-term repatriation opportunity.

Deferred Compensation

The new law requires changes to almost every type of nonqualified deferred compensation arrangement maintained by companies for executives and board members—including certain arrangements that may not have been viewed as deferred compensation previously.

Implications and Considerations

The new law leaves little room for delay as the changes are effective beginning in 2005. Company compensation committees, working with tax, human capital staff, and outside compensation advisors, will need to begin working quickly (if not already) to prepare new or revise existing deferred compensation arrangements to comply with the new law. In many companies, boards or board committees will be asked to review and ratify these new arrangements.

Tax Disclosures and Tougher Penalties

The new law assesses new monetary penalties against companies that fail to disclose certain types of transactions on their tax returns. Penalties imposed by the IRS on SEC registrants are required to be disclosed in SEC filings.

Implications and Considerations

Even before the new law, the IRS penalty provisions were considered among the most complex portions of the Internal Revenue Code and regulations. The new nondisclosure penalties will only raise the stakes for having effective tax risk management policies and processes in place.

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Forward View

by Tapestry Networks

Audit Committees and the War on Terror

"What does your company do when the terror alert code moves from Yellow to Orange?"

That question led to a fascinating conversation at a recent network meeting of audit committee chairs. Indeed, the war on terror has been the main topic of conversation at many similar meetings over the past two years. Even more interesting than the question was the lack of clear answers: audit committee chairs are unaware of their companies' practices in regard to changes in the Homeland Security Advisory System.

Given that the United States has been involved in the war on terror for over three years since 9/11, and with most experts predicting at least a decade-long struggle, how should directors of American corporations become more familiar with their company's terror risk planning, crisis preparedness, and business continuity plans?

Perhaps terrorist activity is simply not regarded as a serious risk for most businesses. A recent survey by FM Global supports such a view, showing that only 1% of executives from Global 1000 companies view acts of terrorism as a serious threat to their business.[1]

Another 2004 survey by AT&T and the Partnership for Public Warning shows that nearly 25% of U.S. companies are conducting business as usual without developing, implementing, or testing contingency plans. This survey also found that companies in cities on Orange alert are only slightly more likely to have such plans in place than companies in lower risk areas.[2]

Indeed, the 9/11 Commission itself noted this lack of preparation: "As we examined the emergency response to 9/11, witness after witness told us that despite 9/11, the private sector remains largely unprepared for a terrorist attack."[3] So, what is the responsibility of the audit committee for risk management, crisis preparedness, and business continuity?

Risk management. Although the New York Stock Exchange listing rules do not require that the audit committee be the sole body responsible for risk assessment and management, they do indicate that audit committees must discuss guidelines and policies for governing the process by which the company handles its exposure to risk. Perhaps the risk of terrorism is no different than any other potentially catastrophic risk and should be subjected to the same approach as any other risk: assessed, managed, and mitigated.

Crisis preparedness. Many industries have their own federally-mandated crisis preparedness standards. The Department of Homeland Security has endorsed the 9/11 Commission recommendation that companies comply with the Emergency Preparedness and Business Continuity Standard (NFPA 1600) developed by the National Fire Protection Association and endorsed by the American National Standards Institute's (ANSI). The Commission wrote, "We also encourage the insurance and credit-rating industries to look closely at a company's compliance with the ANSI standard in assessing its insurability and creditworthiness. We believe that compliance with the standard should define the standard of care owed by a company to its employees and the public for legal purposes." This language also appears in several congressional legislative initiatives on the 9/11 Commission Report.

Many of the audit committee chairs we have spoken to in the last year are integrating their work on risk management with their company's crisis planning (some have even participated in the company's crisis management training). However, audit committees ought to review management's plans for complying with NFPA 1600, particularly if non-compliance is likely to become both a financial and reputational risk for the company.

Business continuity. Prior to 9/11, legal experts also saw a clear role for the audit committee in business continuity (sometimes called disaster recovery): "With the very real threats of both international and domestic terrorism … [the] audit committee should satisfy itself that adequate disaster-recovery programs are in place with regard to the storage and retrieval of electronic information critical to the company's operations. The committee should also review the company's insurance programs to determine whether enough protection is in place for the business and its assets."[4]

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[1] FM Global, "2004 Protecting Value Study," a poll of 600 executives and investment professionals in North America and Europe, June 30, 2004.

[2] AT&T and the Partnership for Public Warning, "Disaster Planning in the Private Sector: A Post 9/11 Look at the State of Business Continuity in the U.S.," October 5, 2004. The survey asked a number of questions to 1,000 executives from 10 large metro areas—New York/New Jersey, Los Angeles, Chicago, Philadelphia, Washington D.C., San Francisco, Miami, Detroit, Minneapolis, and Dallas—with responsibility for their firm's disaster planning.

[3] National Commission on Terrorist Attacks Upon the United States, "The 9/11 Commission Report," July 22, 2004.

[4] Mark Kessel, "Building a better audit committee. What they need, what they must do," ABA Section of Business Law, Business Law Today, January/February 1999.

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Understanding the 2004 Tax Act

Boards and audit committees need to work closely with the tax function and outside tax and corporate governance advisors to assess the company's overall tax risk profile. A recommended course of action is that the company tax director regularly brief the audit committee to explain areas of risk and exposure.

Concluding Thoughts

The American Jobs Creation Act of 2004 requires companies doing business in the U.S., even those headquartered in other countries, to understand a wide range of potential implications, including those at the state and local level. Every corporate function has an important role in understanding how the new law could affect operations, financial statements, and pending and proposed transactions. Board members can support this process through communications with senior management and the audit committee that emphasize the importance of taking a company-wide, integrated approach. ✔

For more information, go to
eyonline.com/auditcommittee

Additional Resources

If you missed our recent Thought Center Webcasts on:

- *Evaluating 404 IT Deficiencies*
- *What You Need to Know: 2004 Year-End Financial Reporting Update*
- *The American Jobs Creation Act: Business Implications for Senior Executives and Board Members*
- Other relevant topics for audit committee members

Go to ey.com/webcast to watch a rebroadcast.

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Forward View by Tapestry Networks

Audit Committees and the War on Terror

Business continuity advisors recommend that audit committees review the company's worst case scenarios to make sure programs can address a potential catastrophe. Committees also need to ensure that the company's program addresses:

- hard issues such as redundant capabilities, succession plans, inventory shortages, supplier disruptions, and real estate issues.
- soft issues including public communications, loss of a critical employee, employee fear, and grief support.

Perhaps the last word should remain with the 9/11 Commission: "Private-sector preparedness is not a luxury; it is a cost of doing business in the post-9/11 world. It is ignored at a tremendous potential cost in lives, money, and national security." ✔

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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