April 2005

BoardMatters Quarterly

Critical Insights for Today's Audit Committee

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A corporate governance survey published in December 2004 by Financial Executives Research Foundation found that 96 percent of public companies surveyed believe their audit committee is effective, but only about two-thirds believe their audit committee members are fully informed of their responsibilities.

In this issue of *BoardMatters Quarterly*, we feature articles on several topics that may be of interest to you and the other members of your board as you continue to clarify your roles and responsibilities and address the issues that company management is dealing with, including:

- *Sustaining Section 404* – Last year's Section 404 implementation project will need to become a sustainable process going forward. Our featured article on page 2 outlines some key considerations your audit committee can contemplate to see that the job gets done.
- *The Market Implications of Section 404 Reports* – Now that companies are beginning to report on their internal controls, including reports of material weaknesses, how is the marketplace likely to respond? The article on page 4 provides Ernst & Young's perspective.
- *Audit Committee Responsibilities* – The article on page 5 provides helpful information as you conduct a self-assessment to determine the effectiveness of your committee. The information on page 6 highlights some things to consider as you work with company management on the emerging compliance agenda.
- *Audit Committee Member Liability* – In the wake of the Sarbanes-Oxley Act, audit committee members certainly have an increased level of responsibility and there is concern about the potential increase in personal liability, particularly for those designated as financial experts. Turn to page 7 for a list of things you can consider to help protect yourself.
- *Audit Committee Leadership Network (ACLN)* – Read page 8 to see some of the issues ACLN members have discussed over the last several months.

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. ✔

Key Considerations for Sustaining Section 404 – Year Two and Beyond

The Public Company Accounting Oversight Board's (PCAOB) requirements relating to Section 404 underscore why companies cannot look at last year's effort as a one-time project that has come and gone, and instead must focus on establishing a sustainable process for this and future years. The PCAOB specifies that each year's Section 404 effort to assess the effectiveness of internal control over financial reporting must 'stand on its own.' As a result, the activities that occurred last year will have to be sustained this year, and in subsequent years, to the extent necessary to achieve compliance.

Audit committees need to take an active oversight role in sustaining Section 404 activities and seeing that the job gets done. Key considerations for this oversight in year two and beyond include:

- What is the same—and what is different—for Section 404 after the first year of implementation?
- Is management setting the right tone at the top for control consciousness in the organization? Is timely action being taken to address both pre-existing and new control deficiencies?
- How do changes in the business impact processes and procedures for both Section 302 and Section 404?
- What role does internal audit play in Section 404 sustainability?

What is the same? What is different?

Given that the PCAOB has yet to perform its first inspections of Section 404 audit work, and that the SEC held a roundtable on April 13, 2005 to further discuss the implementation of Section 404, uncertainties exist as to whether the rules may change over time. Looking at Section 404 sustainability based on the standards that exist today, overall requirements and the basic steps to achieve compliance will be the same this year, and on an ongoing basis, as they were in the first year. However, key areas that may need to be reconsidered over time include objectives, scope, and process.

Objectives

For many companies, the objective for Section 404 implementation projects in the first year was primarily focused on meeting the requirements and deadlines set forth in the rules. Moving forward, new objectives are emerging including cost containment, value generation, and integration of new compliance requirements. Key questions to address in determining the company's objectives include:

- How can the 404 process be completed more efficiently? To what extent can Section 404-related activities be embedded into business units and processes?
- What kinds of future improvements in internal control are needed and/or desired? What value can be derived from process improvements?
- How will the 404 work done in 2005 relate to the quarterly 302 certification process and/or other compliance initiatives?

Scope and Process

The scope of Section 404 work in the first year was significant. While the ongoing scope of these efforts should not be as great as the implementation year, the same basic activities will need to be carried out. The overall process—determining significant accounts, disclosures and relevant assertions, identifying significant processes and locations, updating the relevant documentation and testing strategies, and coordinating and monitoring the process—is still necessary.

Several of the factors that must be considered include:

- How is the organization planning to move Section 404 from a project to an ongoing process?
- Who will take responsibility for the ongoing effort?
- How is the company moving to embed responsibility in the business units for day-to-day documentation, testing, and remediation?
- Do the business units clearly understand their responsibilities? Are they adequately staffed with the right skill sets and are they properly trained? Are specialty resources and/or advisors needed to supplement existing resources?

Tone at the Top

The tone set by the top management of an organization influences the control consciousness of its people, and is the foundation for all components of internal control. It also provides discipline and structure. A primary intent of the Sarbanes-Oxley Act was to reinforce that principle and to improve the corporate environment in which financial reporting occurs.

Audit committees have a critical role in promoting a tone that contributes to the integrity of the financial reporting process, and in assessing and monitoring the tone that is set by management throughout the organization. A key indicator of the control environment's tone that audit committees should consider is management's response to and handling of control deficiencies.

Other considerations of tone at the top include:

- Is management committed to maintaining Section 404 compliance as a top priority? Do management communications set the right tone for control consciousness? Do the resources and budget allocated to Section 404 compliance implementation reinforce it as a top priority?
- Are control deficiencies identified in 2004 being addressed? What is the process to inventory and deal with newly identified issues?
- Are human resources policies and practices consistent with a tone that reinforces control consciousness?

Changes in the Business

After the first year of Section 404 reporting, management is required to disclose in each quarterly report any change in internal control over financial reporting that occurred during the last quarter that has materially affected, or is reasonably likely to materially affect, internal control over financial reporting ("material changes in internal control"). The auditor will perform limited procedures each quarter to provide a basis for determining whether material modifications should be made to management's disclosures about material changes in internal control. Any material changes identified in the quarterly certification process will also need to be considered as part of management's Section 404 assessment work.

Some of the questions that immediately present themselves when considering this topic include:

- Is there a process in place to identify changes in the business that could result in material changes in internal control?
- Has materiality been defined and qualitative criteria established to identify a material change in internal control and/or assess the effect of identified deficiencies on interim financial statements?
- Is the disclosure committee appropriately linked into the process to make disclosure decisions?
- Is the external auditor appropriately involved in the process?

The Role of Internal Audit

In most organizations, internal audit is the primary group which has an understanding of the business process, control concepts, and testing methodologies required to complete the 404 process. At the same time, the audit committees of many companies have traditionally relied on their internal audit departments to focus on the non-financial risks that their companies face.

In the initial year of Section 404 implementation, many internal audit functions were challenged to complete their annual audit plan as they provided skilled resources to participate as members of 404 project teams. Moving forward, companies will need to clearly define the role, if any, that internal audit will play in supporting the Section 404 compliance effort. Considerations for internal audit include:

- How will internal audit support the maintenance of 404? Will it assist with regular testing? How will its role impact the work of the external auditor?
- Will the internal audit department be divided, or will the organization create a new function focused on financial reporting risk? If so, how many people will it require? Where will these skill sets be obtained?
- How will the 404 process affect the risk assessment process and audit plan?
- Will audits of third-party providers become more important or more frequent as a part of Section 404 work or as a part of the organization's overall risk management strategy?

Concluding Thoughts

Although there is uncertainty that Section 404 requirements may change over time, audit committee members need to reflect on the implications of Section 404 beyond the first year of implementation and continue to evolve their thinking. Looking at 404 as a sustainable process, and not a one-year project, will require audit committees to ask different questions and consider new responsibilities as an ongoing part of their oversight role. ✔

Section 404:

How is the Marketplace Likely to Respond to the First Wave of Internal Control Reports?

We are beginning to see the results of the first wave of internal control reporting. Section 404 requires that management and their independent auditor assess and report annually on the effectiveness of the company's internal control over financial reporting. All identified material weaknesses that exist at the company's fiscal year-end must be disclosed in these reports. Now that the marketplace is receiving new information about internal controls, including certain companies that are reporting material weaknesses, how is it likely to respond?

It is impossible to predict with certainty the implications of the new reports to the marketplace. The expectation is that underwriters, analysts, rating agencies, lenders, and other market participants will build consideration of internal control reporting into their decision-making models and evaluation criteria. For companies that report material weaknesses, we believe investors and other financial statement users should carefully evaluate each material weakness to understand its nature, cause, and potential effects on the company's financial statements.

The process of evaluating a material weakness can be complex and often involves many considerations, but it is anticipated that the end result will be that not all material weaknesses will cause the same level of concern in the marketplace. For example, material weaknesses that represent a pervasive deficiency often will cause greater concern than weaknesses that are narrowly confined to a specific account, process, or location. Examples of pervasive material weaknesses could include an ineffective control environment (i.e., overall culture and tone at the top), fraud perpetrated by senior management, or systematic enterprise-wide IT deficiencies. More narrowly confined weaknesses could relate to the accounting for specific types of transactions.

Regardless of the nature of the deficiency, all material weaknesses generally need to be remediated as soon as practicable. Accordingly, a key consideration when evaluating the disclosure of a material weakness should include an understanding of management's plans to remediate the weakness and whether such plans appear reasonable under the circumstances.

In a speech at the 11th Annual Midwestern Financial Reporting Symposium, SEC Chief Accountant Donald Nicolaisen's observations on preliminary reactions from investor groups suggest that he concurs that not all material weaknesses will be viewed with equal significance. Nicolaisen also indicated that he expects a number of companies will announce that they have material weaknesses in their controls and that this finding generally should not be surprising during this first round of reporting. He does not believe that, by itself, the reporting of a material weakness should necessarily be motivation for immediate or severe regulatory or investor reactions.

Material weaknesses can be related to the restatement of previously issued financial statements. However, it is important to remember that a material weakness does not necessarily mean that a material misstatement has occurred, or will occur, in the financial statements. Rather, it indicates there is a more than remote possibility that a material misstatement of the company's annual or interim financial statements will not be prevented or detected by the company's internal controls. Even if a material weakness in internal control is disclosed, the auditor could issue an unqualified opinion on the financial statements concluding that the company's existing financial statements are reasonably assured to be free of material misstatement.

As is relates to regulatory considerations, the SEC staff has stated that an adverse opinion on the effectiveness of internal control over financial reporting by management and/or the auditor generally will not, in and of itself, create a regulatory hurdle to raising capital and accessing the capital markets, as long as the independent auditor's report on the audit of the related financial statements is unqualified and all other reporting obligations are current and timely.

The new reporting requirements are likely to result in more timely identification and remediation of weaknesses in internal control over financial reporting as companies build the evaluation of internal control into their everyday processes. The ultimate goal should be more reliable financial reporting and increased investor confidence.

For further information, refer to Perspectives on Internal Control Reporting: A Resource for Financial Market Participants*, a publication developed by Ernst & Young and three other public accounting firms to help financial market participants understand issues related to internal control reports. It is available online at* www.s-oxinternalcontrolinfo.com. ✔

On March 2, 2005, the SEC announced that it was providing Foreign Private Issuers (FPIs) and non-accelerated filers with an extension to comply with the internal control reporting requirements of Section 404 of the Sarbanes-Oxley Act of 2002. The new effective date for internal control reporting—for both management's assessment and the external auditor's attestation—will now be effective beginning with fiscal years ending on or after July 15, 2006 (previously July 15, 2005).

How Effective is Your Audit Committee?

Audit committees play a key role in the oversight of the financial reporting process—even more so with the new internal control reporting requirements. An effective audit committee can contribute to a strong control environment. How effective is your audit committee? Conducting a self-assessment can be a useful tool to find out.

Certain requirements exist for public companies to assess the audit committee. For example, companies listed on the New York Stock Exchange are required to perform an annual evaluation of the audit committee.[1] The importance of an effective audit committee is evident in this requirement because the independent auditor has to consider *ineffective* oversight by the audit committee to be at least a significant deficiency and a strong indicator that a material weakness in internal control over financial reporting exists.[2]

Even if it is not required, a self-assessment of the audit committee can provide useful information for the committee and the board of directors. Self-assessments can help identify areas where the audit committee needs to improve in order to fulfill its oversight objectives.

Once a self-assessment of the audit committee has been performed and results have been determined, important next steps are to develop an action plan and a means to monitor the implementation of the action plan. Any changes in the responsibilities of the audit committee, or in the way that the committee operates, can be reflected in the Audit Committee Charter and/or in the more detailed Audit Committee Meeting Planner. The audit committee's legal advisors also can provide useful advice when the audit committee is performing its self-assessment process and evaluating and documenting the results of that process. ✔

Matters to consider when performing an audit committee self-assessment:

- *Who should be surveyed?* The audit committee may limit its assessment to audit committee members or consider broadening the scope. Some audit committees have found a 360-degree assessment to be helpful, i.e., the board of directors, key management personnel, and the auditors are all surveyed. The surveys for non-audit committee members need to be tailored for each respective type of respondent, to provide valuable feedback as to how well the audit committee is working with others involved in the financial reporting process, and how others perceive the committee's effectiveness.

  In addition, the audit committee could perform evaluations of individual members, including the audit committee chair. Evaluations might include topics such as time commitment to the work of the committee, financial expertise, ability to contribute, willingness to challenge and hold management accountable, diligence, insightfulness, and leadership skills. These evaluations could prove valuable in determining a succession plan for the chair of the committee.

- *What questions should be asked?* Questions should reflect your committee's situation and responsibilities. The questionnaire should at least address the responsibilities outlined in the Audit Committee Charter and in a more detailed Audit Committee Meeting Planner, as applicable.

  Self-assessment tools are available to assist the audit committee, including several from Ernst & Young (available in the Audit Committee Member Toolkit which is accessible through EY *Online* or your client service partner) and the AICPA (available in the AICPA Audit Committee Toolkit).

- *How will effectiveness be determined?* A rating scale can be a useful way to determine the audit committee's effectiveness in its various areas of responsibility. For example, a 1 to 5 rating scale could be used with 1 defined as 'not effective' and 5 defined as 'highly effective.' Providing space for comments also can provide useful feedback when determining the effectiveness of the committee in a particular area.

- *How often should the survey be performed?* An annual self-assessment can provide timely feedback for the committee and also help the committee determine where to focus its efforts during the upcoming year.

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[1] NYSE Listed Company Manual Section 303A.

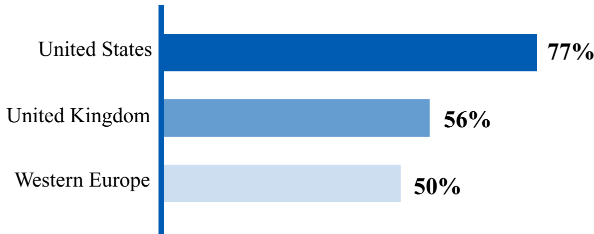
[2] Public Company Accounting Oversight Board Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements,* paragraph 140.

Audit Committees and the Emerging Compliance Agenda

Global Convergence of Audit Committee Responsibilities

Global regulatory and market forces are driving an expanded compliance agenda for many audit committees. This expansion is expected to continue as more audit committees assume responsibility for overseeing compliance with multi-jurisdictional laws and regulations. While compliance practices will continue to vary across nations to align with home country legislation and cultures, we are beginning to see a convergence on a global basis. For example, over three quarters of audit committees in the United States are responsible for overseeing corporate compliance and ethics programs, as are over half of their United Kingdom and Western European counterparts.

Oversight of Ethics/Compliance Programs by Audit Committees



Source: *Ethics Programs: The Role of the Board – A Global Study*. The Conference Board, Inc., 2004

Drivers of the Compliance Agenda

Fraud and unethical behavior were at the root of many recent corporate scandals and failures, resulting in a crisis in confidence in many of the global capital markets. In response, new legislation and regulations were enacted to restore trust in the capital markets, and to bring a heightened level of accountability to corporations and their audit committees. Several of the most significant standards facing global organizations today include:

- Sarbanes-Oxley Act of 2002
- 8th Directive on Company Law
- Organisation for Economic Co-operation and Development's (OECD) country legislation
- 2004 Amended U.S. Federal Sentencing Guidelines

The Sarbanes-Oxley Act in the United States and the 8th Directive in the European Union are two of the more high-profile initiatives. They are reaching into global boardrooms holding boards, and audit committees in particular, accountable for compliance and ethical matters at all levels of the organization.

Compliance Program Considerations

Leading practice organizations are becoming more proactive in managing their compliance risks by instituting programs to prevent, detect, and respond to violations of legal regulations and statutory requirements. Such programs promote ethical behavior, both by and within the company. Considerations for effective compliance programs include:

Elements	Key Questions to Consider
Control Environment	Who owns and oversees compliance? Is there a documented code of conduct? Does the organization's structure and cultural environment encourage compliance? How is performance evaluated and rewarded? What fraud prevention mechanisms are in place?
Risk Assessment	Who is involved in the risk assessment process? Are periodic risk assessments conducted? How are key compliance risks identified and measured? How are key risks managed and mitigated?
Control Activities	Are all management, employees, and company agents effectively trained on compliance matters? Are compliance policies and procedures consistently enforced? How are internal investigations conducted? How are outsourced processes controlled and managed?
Information and Communication	How effective is the company's whistleblower system? Has a formal communication plan been implemented for both employees and other agents? Does the IT system support full and timely compliance reporting?
Monitoring	Who is involved in the monitoring process? Are ongoing compliance reviews and periodic audits conducted throughout the organization? Do high risk areas receive greater monitoring attention?

In the end, 'tone at the top' considerations provide the foundation for an effective compliance program. Audit committees play a key role in assessing, promoting, and monitoring the tone at the top and providing oversight to compliance programs. In this new era, it is critical that audit committees recognize that the bar has been raised for legal and regulatory compliance responsibility. As a further incentive, personal interests are at risk if these compliance programs prove ineffective. ✔

Forward View

by Tapestry Networks

Double Indemnity – The Strange Case of Audit Committee Member Liability

"Do I have a bigger target on my back as a member of the audit committee?" That has been the question on the minds of many audit committee chairs during recent meetings. As one chairperson told us, "The concern that some of us have is that there is a tiered level of responsibility for directors."[1]

These questions concerned audit committee chairs long before 11 former WorldCom directors reportedly agreed to pay $20 million out of their won pockets as part of a settlement with shareholders.[2]

Commenting on the case in the *Financial Times*, three eminent law professors wrote, "The lead plaintiffs... were public pension funds… But because public pension funds are accountable to political officials, there is always the concern that their governance positions may be compromised by politics… If making outside directors pay proves to be good politics, more settlements can be expected, regardless of the governance merits."[3]

In the wake of the Sarbanes-Oxley Act, audit committee members certainly have an increased level of responsibility and there is concern about the potential increase in personal liability, particularly for those audit committee members designated as 'financial experts.' In response, the SEC introduced a liability safe harbor provision in its rules, reassuring audit committee financial experts that such a designation "does not enhance the duties, obligations or liabilities faced by such experts."[4]

Nonetheless, directors are concerned about recent precedents in state law. In the 2004 case *In re Emerging Communications, Inc. Shareholders Litigation* in the Delaware Chancery Court, a director was found jointly liable for $77 million when he was deemed to have breached his fiduciary duty because the court said his expertise, due to his background in the industry and as an investment adviser, meant that he should have known that the price of a transaction was unfair to minority stockholders. One attorney told us that this case might be used to assert that many audit committee members also have this type of specialized financial expertise.

So what can audit committee members consider to assist in protecting themselves? One director, who is also a practicing attorney, recently told us that he had sought a personal liability insurance umbrella policy for protection. However, he was denied coverage due to the perception of increased risk represented by his role as an audit committee chair of a public company.

Attorneys suggest that audit committee members contemplate the following steps so they do not needlessly take on added liability:

- Limit the number of audit committees on which they serve.
- Check that the company's D&O policies offer good and broad coverage.
- Inspect the committee charters and bylaws to check that they have the correct exculpatory provisions.
- Seek a formal indemnification agreement with the company.

Formal indemnification agreements represent an emerging trend among directors and provide funding for the costs of litigation and investigation. If audit committee members feel they have a bigger target on their back, will boards be prepared to offer such agreements to protect them? ✔

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 to 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] Reported in Audit Committee Leadership Network, *ViewPoints*, "Shared responsibility: the audit committee and the board," December 20, 2004.

[2] Gretchen Morgenson, *The New York Times*, "Ex-Directors at WorldCom Settle Anew," March 19, 2005.

[3] Bernard Black, Brian Cheffins, and Michael Klausner, *Financial Times*, "Why directors' damages may harm investors," January 21, 2005.

[4] Chad Conwell, *ClientAlert*, "Increased Liability for Audit Committee Financial Experts?" Paul, Hastings, Janofsky & Walker, LLP, June 2003.

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Issues Discussed During Recent Audit Committee Leadership Network Meetings

As audit committees continue to expand their capabilities, the Audit Committee Leadership Network (ACLN) and the Audit Committee Networks (ACN) share insight, identify emerging best practices, and offer peer support to audit committee chairs and members.

During its December 2004 meeting, the ACLN focused on the shared accountability between boards and their audit committees. Network members exchanged numerous ideas for enhancing the relationship between the two constituents, such as six tips for improving shared responsibility (see sidebar). Other discussion items included managing time constraints around agenda items, approaches for enhancing interaction across committees, and the benefits of sharing information between meetings.

A recent ACN meeting focused on the changing face of the audit committee and the impact this variable role has on committee composition and performance. Members shared techniques on defining the roles around regulatory compliance, committee views on enterprise risk management, and the impact on tomorrow's organization.

In tandem, the committees remain close to issues surrounding Section 404, including controlling costs, resource challenges, and overall planning and reporting for year two and beyond.

To learn more about the networks and to read summaries of their discussions, go to eyonline.com/auditcommittee and click on the Audit Committee Leadership Network tab. ✔

These networks are convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and to share insights into issues that dominate the new audit environment.

Six Tips for Improving Shared Responsibility

1. Clearly articulate to the governance committee and the full board what topics the audit committee will cover, their implications for the board, and when the audit committee will report on them.
2. Schedule board committees' meetings before the full board meets in order to provide real-time summaries of what they have just decided.
3. Add the audit committee agenda to the board book, together with supporting documents for key items raised at the committee meeting, so that all directors see them before any board discussion.
4. Add approval of the audit committee minutes to the agenda for the next board meeting and use this as an opportunity to ask if directors want to dig deeper into issues that may have been discussed only briefly in the audit committee report the first time around.
5. Involve the audit committee chair in developing a syllabus for ongoing education for the full board that would incorporate audit committee topics such as accounting policies.
6. Systematically rotate directors across committees to broaden their knowledge and experience.

For more information, go to eyonline.com/auditcommittee