

BoardMatters Quarterly®

Critical Insights for Today's Audit Committee



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Today's audit committee has many more responsibilities and is increasingly accountable for management decisions than its predecessors. Additionally, the tighter independence requirements, increased liability, and enhanced financial literacy require a considerable commitment from committee members. Members with experience beyond that of the SEC's requirements for a financial expert may help audit committees to become even more effective, despite the shrinking pool of potential expert candidates.

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:

- *Emerging Trends in Internal Controls* - With data collected from more than 250 companies, our newest publication is our most extensive compilation of implementation processes, lessons learned, emerging practices, and specific industry trends to date. The featured article on page 2 outlines some of the key highlights of the Section 404 implementation processes.
- *Fraud Investigations* - Audit committees may need to investigate a variety of issues arising from such sources as an internal whistleblower alleging financial statement fraud or an SEC inquiry. The article on page 4 provides some important considerations when conducting an investigation.
- *Tax Services for Audit Clients* - The PCAOB recently adopted new ethics and independence rules regarding the tax services that public accounting firms can and cannot provide to SEC-registrant audit clients. Learn more on page 6 about the significant provisions of the new rules which will become effective upon approval by the SEC.
- *Audit Committee Chairs and Shareholders* - Research on the existing communication channels between audit committee chairs and institutional investors and their representatives reveals very little interaction between shareholders and the directors elected to represent them. Find out on page 7 if increased communication between the two groups could strengthen financial performance.

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: Navigating the Journey



We have all come a long way—and learned much—since the passage of Section 404 of the Sarbanes-Oxley Act of 2002.

From the outset, Ernst & Young believed it was necessary to survey and report on the progress, activities, and challenges of companies throughout their Section 404 implementation. Beginning in December 2003, we began conducting and publishing a series of Section 404 surveys so that companies could benchmark their progress and identify ways to increase the effectiveness and efficiency of their processes along the way. Our research and experiences will help you benchmark your company's Section 404 process with industry peers and like-size companies, as well as compare and contrast your company's Section 404 approach in Year 2 and beyond.

The newest report, *Emerging Trends in Internal Controls – Fourth Survey and Industry Insights*, published in September 2005, is our most extensive compilation of data, representing more than 250 companies and containing relevant and valuable specific industry and sector trends. Survey respondents included

both company executives and members of Ernst & Young engagement teams. This latest addition to the Emerging Trends series also reflects first-year implementation experiences, lessons learned, Year 2 emerging practices, practical suggestions for improvement, as well as examples of industry-specific significant accounts. This important study serves as a comprehensive reference for accelerated filers, non-accelerated filers, and foreign private issuers alike.

Most importantly, our research validates the assertion that Section 404 implementation has indeed revealed and addressed numerous opportunities for companies to enhance their controls over financial reporting. As companies seek ways to embed and streamline their Section 404 processes, some are looking for ways to leverage the benefits of their learning and implementation approaches to risk areas beyond financial reporting. Many are finding that, although the investment was more extensive than they may have anticipated, so too may be the benefits—for companies and investors alike.

Year 1 Overview

Many opportunities to enhance controls over financial reporting were revealed and addressed, although the effort was larger than most companies anticipated.

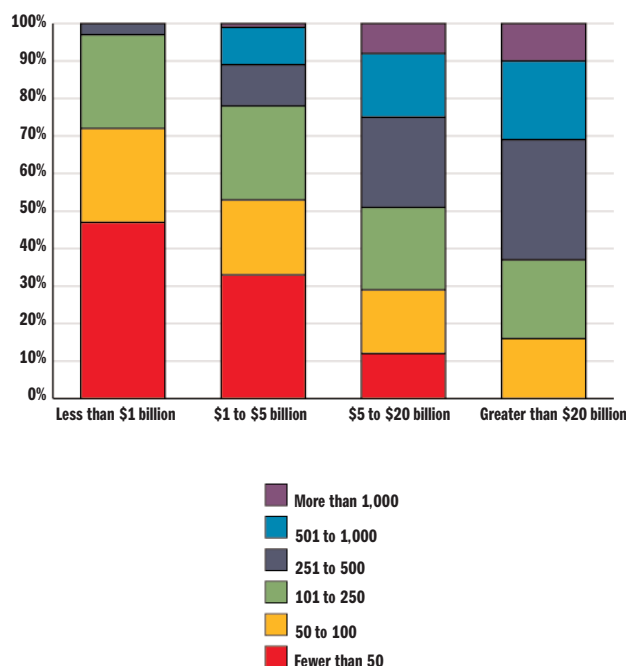
- Over one-fourth of surveyed companies with revenues greater than \$5 billion remediated more than 500 controls prior to initial compliance.
- Over 70% of companies conducted significant remediation of IT systems and controls prior to initial compliance.
- Among 70% of companies, Section 404 costs were over 50% higher than original estimates.

Year 2 Considerations

Section 404 assessment is still a substantial effort and will continue to challenge resources, especially near year-end.

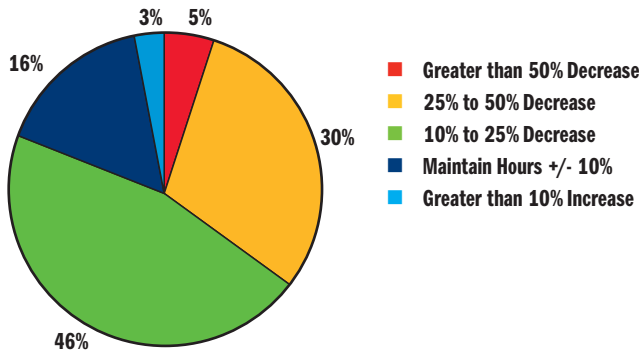
- 58% of companies with revenues less than \$5 billion will dedicate more than half of all internal audit resources to Section 404-related activities.
- A significant portion of Year 2 management testing will be performed in the third and fourth quarters, including testing of entity-level controls.

Number of Control Deficiencies Remediated Prior to Initial Compliance by Revenue Size



- Over 80% of companies still expect to test 75% or more of the controls identified in Year 1.
- 81% of companies anticipate a decrease in internal hours to complete Section 404-related activities from Year 1 to Year 2.
- Leveraging Year 1 documentation was cited as a key contribution of anticipated Section 404 internal cost reductions, albeit one-time in nature.

Year 2 Estimated Percentage Increase/Decrease (Internal Hours)



Items Noted as Key Contributors to Expected Decreases in Year 2 Level of Internal Effort

	Percentage of Companies
Leverage of Documentation from Initial Compliance Year	94%
Refinement of Criteria to Determine Scope of Controls Identified for Testing	57%
Refined Testing Approach	45%
Reduction in Section 404 Project Management Office (PMO) Staffing Requirements	39%
Overall Business Process Improvements	22%
Displace/Replace Manual Controls with Automated Controls	14%

Ongoing Strategy

As companies move forward, sustainability and value will be key points of interest.

- A risk-based, top-down approach to establishing internal scope and testing strategies should help reduce required hours, although a shift may require several years to implement.
- 87% of companies anticipate increased value simply through the enhanced accountability and ownership of controls promoted by Section 404.
- 76% of companies anticipate using some form of control self-assessment to support ongoing Section 404 compliance.
- 53% of companies anticipate deploying an enterprise risk management program within one year.

In our *Emerging Trends in Internal Controls – Fourth Survey and Industry Insights* publication we provide more than 30 questions and recommendations in response to the May 16, 2005, SEC and PCAOB implementation guidance to help management gauge Section 404 readiness and suggested action steps to guide their progress.

We also identify over 60 examples of industry-specific significant accounts for 16 different industries. For each significant account included there is a sampling of items to consider relating to challenges, emerging practices, key risks, and control examples.

We hope these items, coupled with our research and ongoing communications, will help your company navigate the Section 404 journey whether it is in Year 1, Year 2, or beyond.

If you would like to receive a hard copy of Ernst & Young’s *Emerging Trends in Internal Controls – Fourth Survey and Industry Insights*, please email Survey4@ey.com or contact your local Ernst & Young representative. An electronic copy can be found at eyonline.com/auditcommittee under the E&Y Publications tab. ✓

Industries Represented	
Aerospace & Defense	Oil & Gas
Automotive	Pharmaceuticals & Medical Devices
Banking & Capital Markets	Provider Care
Computers & Communication Equip.	Real Estate
Construction	Retail & Wholesale
Consumer Products	Semiconductors
Insurance	Software
Media & Entertainment	Utilities

The Audit Committee's Role in Investigating Allegations of Financial Statement Fraud

Since the enactment of the Sarbanes-Oxley Act and the myriad of high profile accounting scandals, corporate audit committees are finding themselves in the spotlight. Audit committees may need to investigate a variety of issues arising from such sources as an internal whistleblower alleging financial statement fraud or an SEC inquiry. These investigations are frequently conducted against the backdrop of security class actions, regulatory scrutiny, and potential criminal prosecutions. When allegations arise, an audit committee's investigation must be vigilant and must ensure the integrity of the investigative process.

When is an Investigation Warranted?

When faced with an allegation of fraud, an audit committee must first assess the credibility, nature, and extent of the charges, then it must answer the questions of who, what, when, where, and how, while determining the claim's potential effect on the financial reporting process and the company as a whole. The answers to these questions will help the audit committee to decide whether an investigation is warranted. Legal counsel is frequently a useful resource to assist in these determinations. Under the guidance of counsel, the audit committee should assess its own independence and determine whether to create a separate special investigative committee that excludes any individuals that may not be independent of the issues or allegations.

When the audit committee determines that allegations about financial statement fraud require an investigation, what should it do?

Important Considerations in Conducting an Investigation

Retaining Counsel and Forensic Accounting Experts

The audit committee should retain experienced independent legal counsel to help guide it through the numerous legal issues it will face, including privilege, confidentiality, disclosure, and regulatory matters. Similarly, the committee should ensure that counsel retains credentialed and experienced forensic accountants to work closely with counsel throughout the investigation. Counsel and forensic accountants have complementary skills that, together, provide a package that enhances the credibility and integrity of an investigation.

In maintaining the integrity of the investigation, the audit committee must carefully consider the objectivity of both counsel and the forensic accountant.

Identifying, Preserving, and Analyzing Data and Information

The success of any investigation may be limited by the availability of data and information. The investigative team should take steps early to identify all potential custodians of relevant records and electronic data, issue clear retention protocols to company employees, and document all preservation procedures. The committee also should consider requiring counsel to engage outside experts to assist during the document/discovery aspects of the investigation. There is a big difference between a company's internal information technology skill set and the specific skills required to conduct forensic analyses of electronic information. The Securities and Exchange Commission (SEC), the Department of Justice (DOJ), and independent auditors increasingly expect that 'forensic images' of electronic data be made available to them. Mistakes in the area of information preservation may lead to a rebuttable presumption of bad faith in the eyes of regulators and may be difficult to overcome.

One of the most fruitful elements of an audit committee investigation is the review of electronic data. Assuming that appropriate protocols for preserving electronic data have been maintained, 'key word' searches of email, hard drives, server files, and other electronic data sources may reveal the 'smoking gun' or lead to the key findings of an investigation. Analysis of this material requires experienced practitioners and sophisticated computer forensic tools.

When developing key word search parameters, it may be necessary to review them with the company's independent auditor or regulatory body in order to satisfy their demands. Careful documentation of these parameters is extremely important so that procedures performed can be adequately communicated.

Defining the Scope of the Investigation

Defining the scope of the audit committee's investigation is a critical early step. A properly articulated and documented scope keeps the investigation on track, and at the same time enables investigation expansion and/or modification as issues are uncovered and facts are learned. The defined scope should not be limited or restricted in such a manner that the adequacy of the investigation can later be called into question. For example, the scope should include parameters for evaluating other transactions or issues within a similar geography, or similar transactions across geographies. Although the audit committee should work closely with both counsel and forensic accountants to determine a course of action and define the scope, the audit committee is ultimately responsible for the investigation.

In order to enhance the value of the investigation, the audit committee should develop a process that enables its review of the scope of the investigation with the company's auditor and, in the event that a governmental inquiry is involved, with governmental staff. This process should include the receipt of feedback and potential modifications of the investigative scope.

Understanding the Stakeholders of the Investigation

Parallel proceedings are common in conducting audit committee investigations. Other stakeholders the investigative team may need to address include the company's external auditors, prosecutors, attorneys general, the SEC, and self-regulated exchanges. Legal counsel should help the audit committee to understand these issues and to create strategies for addressing them, particularly with regard to reporting matters related to the investigation to the SEC and other regulatory bodies. The NYSE and NASDAQ may also have specific demands regarding the audit committee's investigation in order to fulfill listing requirements.

Determining the Output of the Investigation

It is important to document the investigation's results in some form. In certain circumstances, a full written report regarding the investigation's approach, scope, and findings is required, while in other circumstances an oral report is sufficient.

Government regulators and other interested parties may have specific requirements or demands regarding the audit committee's report. For example, the continuing listing requirements of NASDAQ may require that the audit committee report on any control weaknesses identified during the investigation and the specific remediation efforts that the company has undertaken or will undertake. Legal counsel should evaluate with the audit committee the various options for reporting the outcome of the investigation.

Interviewing Personnel

Employee interviews are one of the most effective means of gathering relevant information and often become the center of an investigation. The investigative team first needs to identify which employees should be interviewed, and in which order the interviews should take place. Often an investigation requires that individuals be interviewed more than once.

The information gathered from the document and electronic data reviews serves as the subject matter to prepare for the employee interviews. Forensic accountants and lawyers should work together to prepare an outline for the interviews and agree to the protocols for note taking. Interview memoranda should be prepared following each interview to serve as a permanent record of the session. The investigative team should maintain a log of who was interviewed, on which date, and by whom.

Interacting with the Independent Auditor

Notifying the company's independent auditors about a potential investigation is an important early step to consider because the investigative plan should also address the independent auditors' concerns. Independent auditors are becoming more active in evaluating the scope and rigor of an audit committee investigation, and they may assign forensic accountants from their own firm to 'shadow' the work of the audit committee's investigative team, in order to help assess the scope and conclusions of the investigation.



In most cases, the independent auditors will be unable to complete their review or audit of the company's financial statements until the audit committee's investigation is completed. This is often the case whether the expected effects of the allegations involve current or prior period results.

Preparing a Report on the Investigation's Findings

Investigative reports typically cover a wide range of issues, analyses, and evidence. They often provide detailed insight into the facts uncovered during the investigation and an analysis of accounting issues or literature. Whether a report on the investigation's findings is in written or oral form, it should contain both a detailed explanation of the allegations that gave rise to the investigation and an explanation of the resulting investigative scope. A complete list of the individuals interviewed and the sources of data and information should be provided.

An assessment of internal control weaknesses identified during the investigation is often reported, along with recommendations for remediation. Any accounting adjustments that may be required should be detailed, along with a thorough explanation of the basis for such adjustments. To the extent that any personnel actions or management reforms are necessary, the report should contain sufficient background and detail to support those actions.

Summary

The audit committee's conduct during the investigation will be scrutinized by a number of interested parties, including regulators, auditors, and the financial markets. These parties will expect the audit committee to take control of the process and define an investigative scope that rigorously investigates the issues at hand, while being broad enough to provide a reasonable basis for the audit committee's conclusions. The audit committee's leadership of the investigative team when responding to allegations of financial statement fraud is a critical factor in ensuring the integrity of the investigative process. ✓

**Please turn to page 8 for information
about an Ernst & Young survey and
an upcoming webcast on this subject.**

New Ethics and Independence Rules Establish What Tax Services Auditors May Perform for Audit Clients



On July 26, 2005, the Public Company Accounting Oversight Board (PCAOB) adopted new ethics and independence rules on the tax services public accounting firms can and cannot provide to SEC-registrant audit clients. Providing important and welcome guidance, these rules are designed to present a clear distinction between tax services that impair auditor independence and those that do not.

In addition to outlining tax services that impair independence, the new rules also emphasize the importance of the audit committee's role in pre-approving permitted services and specify the type of information a public accounting firm must discuss with the audit committee during the pre-approval process.

Highlighted below are some of the more significant provisions under the new rules, with a focus on the potential effect on activities of the audit committee. The new PCAOB rules will not become final until approved by the SEC.

Overview of the Rules

Permitted Services

The PCAOB's new rules provide that accounting firms can generally continue to provide tax services to audit clients, including:

- Routine tax return preparation and tax compliance services.
- General tax planning and advice services.
- International assignment tax services, so long as they do not constitute legal or other services which are not permissible.
- Employee personal tax services.

The provision of these services must, of course, be pre-approved by the audit committee.

Proscribed Services

Under the new rules, a public accounting firm may not offer or assist SEC audit clients with confidential transactions or 'aggressive tax position transactions' (including transactions the Internal Revenue Service identifies as 'listed' transactions). Aggressive tax position transactions are transactions that: (1) are initially recommended by the audit firm, either directly or indirectly, (2) have tax avoidance as a significant purpose, and (3) have a 50% or

less chance of being allowed under applicable tax laws. The rules do not bar auditors from advising audit clients against entering into such transactions.

The rules also prohibit a public accounting firm from providing tax services to a person who is in a financial reporting oversight role (FROR)¹ at the SEC audit client, or to an immediate family member (spouse, spousal equivalent, or dependent) of that person. They do not, however, prohibit auditors from providing tax services to individuals who (1) are in a FROR only because they serve on the audit client's board of directors or other governing body, (2) are in a FROR at an affiliate of the audit client (provided the affiliate's financial statements are not material to the audit client's, or the affiliate's financial statements are audited by another accounting firm), or (3) move into a FROR after the auditor has started doing tax work for them (provided the tax work ceases within 180 days after the hiring or promotion).

Audit Committee Pre-Approval

The rules specify the audit committee's pre-approval process for permissible tax services. Under the rules, the accounting firm must:

- Provide written documentation outlining the scope of the proposed service and the proposed fee structure for the service.
- Discuss with the audit committee the potential effect of the service on the firm's independence.
- Describe, in writing, any amendment to the engagement letter or any other agreement relating to the service.

Also, if an accounting firm receives fees or other consideration from a third party for promoting, marketing, or recommending a tax transaction covered by the service, it must disclose those fees, in writing, to the audit committee.

Conclusion

The PCAOB's rules distinguish between tax services that may impair independence and those that do not. The rules permit SEC-registrant companies to use their independent auditor for a range of tax services (subject to the requirement of audit committee pre-approval), but preclude tax work in the specific circumstances discussed above. ✓

¹ The rules define a FROR as a role in which an individual is in a position to or does exercise influence over the contents of the financial statements or anyone who prepares them (such as the CFO, president, etc.).

Forward View

by Tapestry Networks

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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Why Aren't More Audit Committee Chairs Meeting Regularly With Their Shareholders?

Why would institutional investors start making demands to elect their own audit committee when they don't talk to the one they have indirectly elected now? That question was left hanging in the air after this year's International Corporate Governance Network (ICGN) Annual Conference in London, in July.

The ICGN has members in more than 30 countries and includes institutional investors with assets in excess of \$10 trillion. During the conference, a workshop was held on "Auditors and accountants: what do investors need?" Conference participants heard one member of the investor community argue for electing the audit committee directly. He maintained that institutional investors should be able to commission their own audit opinions and initiate extra audits beyond the scope agreed by the board's audit committee, external auditor, and management.

Yet, when Tapestry Networks conducted research among audit committee chairs and the investor community¹, we discovered very little communication between shareholders and directors. Many directors described experiences similar to that of one audit committee chair, who told us, "I'm on four boards and I've never heard of one independent director meeting with a shareholder directly."

This may be due in part to a view we heard frequently from directors: that they are not in favor of increased contact between the audit committee and investor community, except in special circumstances when accounting issues affect stock price.

Much of the directors' reluctance to meet individually with shareholders stems from disclosure concerns. Ironically, the Securities and Exchange Commission's (SEC) Regulation Full Disclosure (Reg. FD)², intended to encourage transparency, deters directors from communicating with their shareholders.

Audit committee chairs also face a somewhat confusing dilemma. While they believe their role is to help create long-term value and

represent a long-term shareholder perspective, they generally perceive institutional investors to be short term in their orientation. Audit committee chairs are left with no choice but to represent 'shareholders' as a broad concept. They are mindful of their duty to represent the interests of all their investors, yet are aware that it is not possible to communicate with a myriad of individual investors.

Institutional investors hold about 60% of the shares of U.S. companies³, but even within a particular institution, identifying with whom directors should speak is not easy. Furthermore, most of the audit committee chairs we spoke with believe that the traditional channels—quarterly earnings calls, annual shareholder meetings, and correspondence—are sufficient.

Certainly, investors bear some responsibility, as few investors actively reach out to directors. "It never occurred to me to contact a director outside times of crisis; I didn't expect they would take my call," one investor admitted.

However, this perspective may not fully take into account the benefits that might accrue if communication increases:

- Hearing investors' concerns may help directors improve performance and deter costly shareholder proposals.
- Forging relationships in good times may create an ally for boards in more difficult times.

The U.S. Council of Institutional Investors, a member of ICGN, declared, "Companies that improve their board-shareowner communications will strengthen their long-term financial performance by not only retaining and attracting investors, but also learning from them."⁴

As one investor put it, "If [a board director] ... were to call to ask me to lunch, I'd go for it in a second ... I would be surprised but pleased if a board member were to contact me proactively." ✓

¹ Audit Committee Leadership Network, "Communication between corporate boards and investors," *InSights*, July 25, 2005. A copy of the original article can be accessed at www.eyonline.com/auditcommittee (click on the Audit Committee Leadership Network tab at the top of the screen).

² Securities and Exchange Commission, Final Rule: Selective Disclosure and Insider Trading, October, 2000. Full text available at <http://www.sec.gov/rules/final/33-7881.htm>.

³ Murray Steele, "Time for investors to come in from the cold," *Financial Times*, May 19, 2005.

⁴ Council of Institutional Investors and National Association of Corporate Directors Task Force, *Framework and Tools for Improving Board-Shareowner Communications*.

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SCORE Retrieval File
No. CJ0025

Recent Developments

Update on the Exposure Draft on Accounting for Uncertain Tax Positions

On July 14, 2005, the Financial Accounting Standards Board (FASB) issued an Exposure Draft of a proposed Interpretation, *Accounting for Uncertain Tax Positions— an Interpretation of FASB Statement No. 109*. As anticipated, the FASB proposed an ‘asset recognition approach’ (applying a dual threshold) to account for uncertain tax positions, formerly referred to as ‘tax reserves.’ The proposed Interpretation would apply to all open tax positions, including those acquired in business combinations, with a proposed effective date as of the end of the first fiscal year ending after December 15, 2005. The FASB accepted comments through Monday, September 12, 2005, and a number of companies commented on the difficulties they anticipate in implementing the Standard as currently drafted.

The proposed Interpretation—which likely won’t become effective this year due to the level of work most companies would need to perform to implement it—will be one of the more significant changes in tax accounting since FAS 109. We will provide updates and analysis when the FASB provides additional information.

Upcoming Webcast

Ernst & Young will host a Thought Center Webcast, *Responding to Allegations of Fraud—What Directors & Officers Need to Know*, on Friday, November 18, 2005. Targeted for directors and officers of *Fortune* 1000 companies, the webcast will address a variety of issues facing board members and public company officers today. We will also discuss the various aspects of audit committee investigations and the results of a survey that Ernst & Young conducted of directors and officers. The panel will consist of Ernst & Young partners Dean Bunch, David Hoffman, and Steve Hurst, and Tom Dougherty from Skadden, Arps, Slate, Meagher, and Flom, one of the country’s foremost authorities on the roles and responsibilities of officers and directors.

Go to www.ey.com/us/webcastsurvey to learn more and to register for the free webcast.

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