

BoardMatters Quarterly

Critical Insights for Today's Audit Committee

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We are pleased to introduce *BoardMatters Quarterly*, a newsletter for audit committee members. In each issue, we will share insights on a variety of topics, gathered from our work with audit committee members and the European Audit Committee Leadership Network, a group of audit committee chairs from some of Europe's leading companies.

The rapidly changing regulatory landscape in Europe now requires more dialogue and interaction between audit committees and the auditor. Ernst & Young's involvement extends beyond the need to communicate with you about the audit or other required work. We want to bring you relevant and timely information about key issues and to share emerging best practices with you.

We first published *BoardMatters Quarterly* in the U.S. in December 2003 and have covered some of the following topics: the Sarbanes-Oxley Act, risk management, internal controls, disclosure controls and procedures, control deficiencies, whistleblowers, audit committee composition, audit committee charters, tone at the top, the Public Company Accounting Oversight Board, stock options and other share-based payments, and the changing role of internal audit. If you would like to view any of those back issues, or our other audit committee-related resources, please go to eyonline.com/auditcommittee.

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. Send your feedback to Lisa Hallman at lisa.hallman@ey.com. ✓

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IFRS Conversion: The Role of the

The biggest governance challenge facing most of the 7,000 listed companies in the European Union this year is the conversion to International Financial Reporting Standards (IFRS). Although the EC Regulation requires IFRS to be applied for the first time in companies' 2005 full year financial statements, most European listed companies will either be required to do so by national securities regulators or will choose to apply IFRS in their quarterly or half year 2005 reports. Although many companies are now well advanced in their preparation for conversion to IFRS, some are not and are still laboring under the illusion that IFRS is not much different from local GAAP.

Among the key issues for boards is how to monitor the quality and integrity of companies' internal conversion process, and how to ensure that the communication to investors of the impact of IFRS on reported results does not have an adverse share price impact that is not justified by the underlying facts.

Major Task

The change to IFRS is fundamental for countries whose national accounting standards are not based on a balance sheet fair value model of accounting. For countries whose national accounting standards are, to an extent, based on this model, the change will nevertheless be far reaching. This is because the new and revised accounting standards issued by the International Accounting Standards Board (IASB) are far more complex and detailed than those they have replaced. Since November 2003, the IASB has issued over 3,000 pages of standards and guidance—three times as long as “War and Peace.”

The fact that many of the standards are new, and the interpretations and guidance on them are still evolving, further complicates the matter and increases the

implementation risk, while the increased earnings and equity volatility that arises from the IASB's asset/liability fair value approach increases the investor relations risk.

Who is Responsible?

Although no board would deny that it has ultimate responsibility for the quality and integrity of the IFRS conversion and the way in which its impact is communicated to the capital markets, our experience is that there are very different views among boards and audit committees about how this responsibility should be discharged.

At one extreme, there is a strongly expressed view that IFRS conversion is essentially a management challenge, rather than a task for the board. In a recent meeting with audit committee chairs from some major European companies, one chairperson said, “Each business must organize itself appropriately. We are interested in outputs, not the process of getting there.”

The more commonly held view, however, is that audit committees must understand the rationale behind management decisions for selecting particular accounting policies, in addition to understanding and monitoring the process. As one chairperson put it, “The accounting change is huge. Significant resource is needed. Internal controls need to stand up to these new standards.” Another explained, “As audit committee chair, I have been interested in this as a communication process. There is also a behavioral component about how to manage the company differently.”

IFRS Conversion is Far More Than a Technical Accounting Exercise

Clearly, it is important for the board to be confident that the finance personnel in the group have an appropriate degree

of IFRS financial competence, that appropriate guidance on the application of the company's IFRS accounting policies is made available, and that the IFRS conversion project is well planned and managed. One useful approach to assess preparedness is to benchmark the organization's current IFRS status with companies of a similar size or in a similar industry. However, the responsibility of board members goes beyond monitoring the IFRS conversion process.

Conversion is not just a technical accounting exercise because it may have significant impacts on the way companies operate and how IFRS may affect transaction structures. For example:

- Sales contract pricing may include embedded derivatives that need to be accounted for separately.
- Information systems must be able to collect data to meet the new accounting recognition and measurement requirements in relation to revenue recognition on long term contracts or components of fixed assets previously regarded as single assets.
- Treasury operations and systems may be affected by the highly prescriptive IFRS hedge accounting rules. Far greater use of valuation models, together with the data required and the assumptions to be employed, will be required in order to apply IFRS.
- Pensions, share-based payments, asset impairment, and financial instruments will all require the use of models and assumptions about future performance and cash flows.
- Capital instruments previously classified as equity may have to be classified as debt under IFRS (or bifurcated with an element being treated as debt and the balance as equity), thereby affecting gearing.

Of great importance for senior management and boards, the accounting recognition and measurement changes brought about by IFRS will affect the measures used by companies and investors to assess the performance of companies and, as a consequence, may lead to a realignment of management's performance targets and performance-related remuneration. Boards will have to assess the impact of the changes resulting from IFRS on dividend policy.

Boards need to understand the significance of these issues in order to assure themselves that management has addressed them properly. For example, boards or their audit committees need to be able to assess the appropriateness of the assumptions used by management to value pension scheme assets or to determine whether assets are impaired, as quite small adjustments to the underlying assumptions may give very different results.

It is therefore essential that those charged with governance should develop a good understanding of the organization's approach to conversion and receive regular progress reports and summaries of key issues.

Can Boards Handle It?

Boards need to consider their own competence, including whether they have, not just a degree of financial and accounting expertise, but sufficient awareness of IFRS to play the appropriate role in questioning the choices of management. For example:

- Can the group challenge management's choice of accounting policies and the robustness of the transition process?
- Can they evaluate the impact of IFRS on areas of accounting involving significant levels of judgment?
- Can they assess the clarity and compliance of disclosures and explanations relating to IFRS implementation?

What is the Status of Your Conversion?

Top Quartile

- Conversion is at an advanced stage and all IFRS decisions taken
- IFRS processes and procedures are in place
- Systems modifications have been made
- Rewriting of the group reporting manual is complete
- Training is in process on a global basis, including audit committee familiarization
- Restatement of opening 2004 balance sheet is complete and restatement of 2004 results is well progressed
- Auditors have reviewed IFRS accounting policies and issues arising have been resolved
- Detailed plan prepared of timing and content of market communications

Bottom Quartile

- Comprehensive IFRS impact study has not been completed or implementation had not yet commenced
- The amount of work involved and the resources needed have been underestimated
- Accounting staff are not being trained
- Little or no involvement of auditors
- Board or audit committee are not fully engaged or briefed
- No clear plan on market communication

Questions for Boards and Audit Committee Members

Questions to Ask Yourself

- Have you equipped yourself to challenge management on IFRS issues?
- What is your new frame of reference for making those challenges?
- What training do you require to enable you to provide an appropriate degree of input?
- How well do you understand how your company will be affected and to what extent?
- Are you familiar with the nature, content, and timing of the company's planned IFRS communications with the market?
- How can IFRS financial statements provide information that better enables you to evaluate management performance, forecast value, and make sound investment decisions?
- Does the company's performance-related remuneration structure need to be redefined?
- Could the change to IFRS require a change in dividend policy?

Questions to Ask Management

- What are the plans for training finance staff and the board?
- How is change in processes and systems being managed?
- What should be communicated? When does the market need the information? How could it be interpreted?
- What is the planned approach to educating analysts and major investors?
- How will the analysts understand our underlying performance and maintainable earnings?
- Will IFRS have any impact on our credit rating or debt covenants?
- To what extent will we make greater use of pro forma reporting and non-GAAP measures in explaining the company's performance?
- To what extent will we need to redefine our business segments and rethink the basis on which we report segment information?

There may well be a need for the board to consider additional focused training to address these issues. Audit committees should ensure that the company's auditors are involved throughout the conversion process and request regular reports from them giving their view of the quality, integrity, and timeliness of the process.

Stakeholder Communication is Key

One of the major challenges facing boards and management is the effective communication of necessary changes to shareholders. As one audit committee chair commented, "IFRS is an exercise in communication, not technical accounting. ... Shareholders have never really understood what goes on in the accounting engine."

The fact that most analysts do not appear to be equipped to deal with the changes in accounting makes it particularly important that the changes brought about

by IFRS are explained clearly, both in quantitative and qualitative terms. As well as the content of the communication, timing is a particularly crucial question on which the board needs to be clear. Many large groups have published their 2004 results under IFRS either at the same time, or shortly after, publishing their results under their national GAAP, in order to reduce the possibility of negative market reaction and to ensure that discussions focus on the underlying performance, and not the accounting cosmetics.

Time is Running Out

Management in every company will be responsible for the operational planning and implementation of the IFRS transition, but ultimate responsibility lies with those charged with governance. Time is fast running out for boards which have not so far played their full role. ✓

Forward View

by Tapestry Networks



The Ever-Shrinking Audit Committee Talent Pool

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

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

If current directors sit on fewer boards and then either refuse to serve on the audit committee, or are deemed not qualified to do so, the talent pool will be in danger of becoming a talent puddle.

There are many reasons why this might come to pass:

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

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

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

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

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

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

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¹ "Restoring Trust," Report to The Hon. Jed S. Rakoff, The United States District Court for the Southern District of New York On Corporate Governance for the Future of MCI, August 2003.

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

³ *ibid*

How Effective is Your Audit Committee?



Audit committees play a key role in the oversight of the financial reporting process—even more so as a result of the 8th Directive on Company Law. An effective audit committee can make a significant contribution to a strong control environment. How effective is your audit committee? Conducting a self-assessment can be a useful tool to find out.

Audit committee assessments are a fact of life. Companies listed on the New York Stock Exchange, for example, 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 treat *ineffective* oversight by the audit committee as a significant deficiency and a strong indicator of material weakness in internal control over financial reporting.²

Even if there is no formal requirement, 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. ✓

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.

Committee?

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

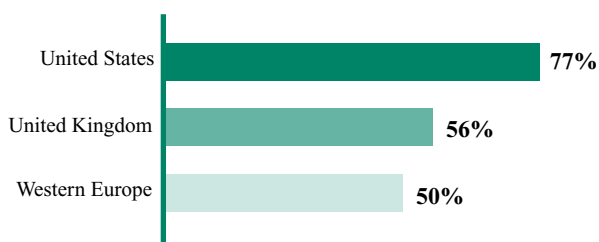
- **Who should be surveyed?** The audit committee may limit its assessment to audit committee members or consider broadening the scope. Some audit committees have found a 360-degree assessment to be helpful, seeking opinions from the board of directors, key management personnel, and the auditors. Surveys of 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.' Since the rating process is essentially subjective, providing space for comments also can generate useful feedback.
- **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.

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 U.S. are responsible for overseeing corporate compliance and ethics programs, as are over half of their UK 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 companies and their audit committees. Several of the most significant standards facing global organizations today include:

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

The 8th Directive in the EU and the Sarbanes-Oxley Act in the U.S. 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 of 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. ✓

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 it 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 2 March 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 15 July 2006 (previously 15 July 2005).

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The European Audit Committee Leadership Network

As audit committees expand their responsibilities, the newly-formed European Audit Committee Leadership Network (EACLN) shares insight, identifies emerging best practices, and offers peer support to audit committee chairs and members.

The EACLN is a group of audit committee chairs from some of Europe's leading companies. They are committed to improving the performance of audit committees and helping to enhance trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit environment.

During its first meeting in December 2004, the EACLN discussed "Section 404: Challenges Facing European SEC registrants."

During the discussion, members stated their views that:

- Companies are actively seeking value from Sarbanes-Oxley compliance.
- Section 404 implementation is currently on track but, at least in the short term, is likely to generate more cost than benefit.
- International Financial Reporting Standards will complicate Section 404 implementation.
- There are opportunities to learn from companies that are completing the process.

To learn more about the EACLN, several other audit committee networks in the U.S., and to read summaries of their discussions, go to eyonline.com/auditcommittee and click on the Audit Committee Leadership Network tab. ✓



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

If you have feedback on this issue or would like to suggest a topic for a future issue, contact Lisa Hallman at lisa.hallman@ey.com