



# 2004

Current developments for  
audit committees



# To Our Clients and Friends

A year and a half has passed since the Sarbanes-Oxley Act was enacted, and we continue to feel its effects as the SEC and the stock exchanges implement new rules aimed at restoring public confidence in the capital markets. These rules are changing the landscape of corporate America—from how we structure our boards and committees, to new board and committee responsibilities, to governance disclosures, to company processes and internal control systems, to how the auditing profession is regulated. Some observers fear that with all this effort directed to compliance, we're losing sight of running our businesses.

To support directors who are at the center of these changes, we've prepared this publication, which is the latest in a series of communications designed to highlight significant events related to our rapidly changing environment and discuss their implications.

In the current environment, disclosure continues to be the watchword. A few years ago, this publication summarized a Financial Accounting Standards Board (FASB) project that focused on identifying the redundancy between financial statements, annual reports, and other SEC filings, with the objective of reducing that redundancy. It appears there has been a reversal in thinking, with more and more information now required to be disclosed, and new rules that in some cases actually require the same information to be repeated in different places. In terms of new disclosures, key committee charters, board governance guidelines, and codes of conduct have to be posted on company websites. Disclosures about audit committee financial experts, nominating processes, and shareholder access to directors are required in various SEC filings. And the SEC has issued guidelines for MD&A disclosure, seeking to make it more expansive, and requesting additional information for non-GAAP measures companies present.

From a global perspective, both accounting and auditing standard setters continue to strive for convergence of international standards. And the effects of U.S. governance reforms are spreading to other countries, as many of the Sarbanes-Oxley requirements have international impact, and some foreign companies voluntarily adopt other governance reforms.

Against this backdrop, companies must deal with newly effective accounting requirements, among them new guidance on revenue recognition and FASB standards on financial instruments, derivatives, and variable interest entities. And major projects are underway at the FASB that will change the way companies account for business combinations and equity-based compensation.

We believe that providing you with timely information is critical to meeting existing and future requirements, and we will continue to keep you apprised through these and other communications. We are committed to helping you enhance audit committee performance, the financial and business reporting process, and, ultimately, the quality of corporate reporting. We would be pleased to help you on any of these issues and bring the full benefit of PricewaterhouseCoopers' knowledge and resources.



P. Gregory Garrison  
Americas Leader,  
Assurance and Business Advisory Services



Garrett L. Stauffer  
Corporate Governance Leader

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# Corporate governance information available

Website	Description
<a href="http://www.pwc.com/uscorporategovernance">www.pwc.com/uscorporategovernance</a>	Focuses on U.S. corporate governance developments, with links to relevant PwC and other select publications, most of which are in downloadable format. Also allows ordering of hard copies of most publications.
<a href="http://www.cfodirect.com">www.cfodirect.com</a>	PwC's online resource for senior financial executives, providing news, PwC analysis, and financial and business tools.
<a href="http://www.pwc.com/corporatereporting">www.pwc.com/corporatereporting</a>	Provides a global perspective on corporate reporting, including corporate governance and audit issues. Includes downloadable publications and information on financial reporting, corporate governance, and audit developments around the world.

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# Executive summary—impact on audit committees

Here is a summary of the issues covered in this publication, on which we expect audit committees will want to focus particular attention this year in carrying out their responsibilities.

## A brave new world for audit committees

Audit committees coped with unprecedented change over the past year, and many took forceful action to respond; indeed, many already are complying with the plethora of new rules in advance of required dates. But to the extent audit committees have waited for the final NYSE and NASDAQ rules before updating charters and procedures, they will want to turn attention immediately to charter updates and related new processes. And as all committees start to address new responsibilities, they'll want to periodically assess whether they are meeting frequently enough and for sufficient time to fulfill their responsibilities effectively.

Regardless of whether the Public Company Accounting Oversight Board's (PCAOB) final auditing standard pertaining to 404 attestation reports explicitly calls for the external auditor to evaluate audit committees' effectiveness, audit committees should evaluate periodically whether they are effectively performing their oversight role, including staying focused on overseeing external financial reporting and internal control over financial reporting. In performing this evaluation, committees may wish to look at some of the same factors enumerated in the PCAOB's proposed auditing standard. And they may wish to link this assessment with the broader assessment that many committees will be performing under the new NYSE rules.

Despite changes already implemented, audit committees' work is by no means done. Over the upcoming year, they'll pay close attention as Sarbanes-Oxley 404 assessment work picks up steam, and will want to quickly address any findings of concern that arise. They'll recognize that significant effort and resources will be needed for Section 404 compliance, and will monitor status closely. They'll also oversee the first wave of accelerated filing deadlines, which may challenge some management teams. All in all, it portends to be a challenging year.

Fortunately, audit committees can draw on a number of resources for support and information, including publications such as this one. Numerous organizations, conferences, and "colleges" provide training for audit committee members. Additionally, the American Institute of Certified Public Accountants (AICPA) has issued a new Audit Committee Toolkit to support audit committee members in fulfilling their evolving responsibilities. Of interest to committees seeking to recruit new members, the AICPA also has established a database with names and profiles of CPAs who are interested in serving on audit committees. Companies may search the database for individuals who match their needs.

## Continuing focus on boards

Boards' expanding responsibilities pose significant challenge for directors. Boards already are finding that concerns about time commitments, liability, and reputation are making it increasingly difficult to recruit new members. And although audit committee members look at their own full plates, many also find themselves devoting additional time to other board matters, either through service on other committees or through the longer board meetings resulting from increased attention to discharging board responsibilities.

And boards are under more scrutiny regarding their behavior. The past year has seen the emergence of numerous corporate governance rating schemes, administered by various organizations that now demand additional information from management and directors about the state of governance. Such ratings—and uncertainty as to how they ultimately will be used—are focusing boards' attention anew. And issues like executive compensation are expected to remain at the forefront of shareholders' and observers' concerns.

## Continuing focus on boards (continued)

Directors will want to understand key elements of both the Conference Board and WorldCom reports' recommendations, and be comfortable with how their own practices compare. And directors who serve on nonprofits will want to extend their focus on governance effectiveness to those organizations, understanding the implications and ensuring special challenges are addressed.

## SEC focus

Audit committees play a vital role in establishing and enforcing the tone at the top. This role is key to two new SEC rules on ensuring appropriate ethical conduct and clarifying that any attempts to improperly influence auditors will not be tolerated. More audit committees are having explicit discussions with management on these issues, ensuring expectations for ethical behavior are crystal clear. Audit committees also will want to keep in mind the key areas the SEC found as being most susceptible to fraudulent financial reporting—in particular, improper revenue and expense recognition—and understand how they might be present in the financial statements the committee oversees. And, although they should have faith in their management team—otherwise, the board should replace management—audit committees should maintain a questioning and vigilant stance when discussing issues with management, and determine whether management's actions and attitude strengthen or undermine the trust the committee places in the team. And committees will be committing additional time to reviewing financial reports and filings—by taking the time to consider whether they make sense and tell the story of the company's results and challenges.

## Evolving rules for auditors

Audit committees should be aware of the new scrutiny being placed on audit firms, and that the PCAOB is contacting some audit committee chairs of companies whose audits it is inspecting, to discuss the effectiveness of the external auditors' communications. This focus on communications should prompt committees to carefully consider the quality of auditor communications and to discuss any concerns with their auditors. Audit committees of private companies considering initial public offerings will want to ensure their auditors are registered with the PCAOB so that, when the company goes public, regulators will accept the auditors' report. And on the topic of auditors' reports, committees can expect to see new wording, referring to PCAOB standards instead of generally accepted auditing standards.

Audit committees need to appreciate the significant effort entailed in upcoming 404 reporting and will want to understand the approach auditors will be taking in upcoming 404 attestation. With 404 reporting and the continuing focus on fraud, audit committees will be paying particular attention to any internal control deficiencies, misstatements, and fraud risks that come to light during the 2003 reporting cycle, with an eye to any implications for current disclosure requirements and, ultimately, management's and the auditors' reporting in connection with 404 provisions. And committees will want to take a fresh look at their oversight responsibilities and practices regarding the company's procedures designed to prevent and detect fraud, incorporating any new information they're receiving from complaint processes, and ensuring they are communicating with the auditors on such issues.

As part of assessing auditor independence, audit committees will need to fully understand the new rules that apply—those enumerated by the SEC as well as the stock exchanges. Committees also will be reviewing new and more robust disclosures of fees paid to auditors and considering other proxy statement disclosures about their preapproval policies and practices. And audit committees of companies that are considering future public offerings will want to carefully consider their relationships with their auditors going forward, to ensure any nonaudit services provided by the auditors, and any company hiring of audit firms' employees, don't taint the auditors' independence—making them ineligible to sign the three years of audit reports needed.

## The international scene

The focus on restoring public trust in financial reporting has gone international. And along with new recommendations for companies, auditors, lawyers, investment bankers, standard setters, and regulators, come calls for greater board and audit committee involvement. How? Through active roles in monitoring ethical conduct, evaluating management performance, setting appropriate management compensation, communicating directly with internal audit, and assessing their own performance. International convergence of accounting and auditing standards is inevitable, with the European Union embracing global standards in 2005. And the sheer volume of companies that will be implementing the changes, as well as interrelationships between U.S. and European companies, mean U.S. companies will have to become conversant with—and, in some cases, apply—International Financial Reporting Standards. Foreign issuers accessing U.S. securities markets are facing new governance rules, many similar to those for domestic companies, with the only difference being a later implementation deadline for some rules. Audit committees need to recognize emerging accounting and other standards and the implications for their companies, and discuss with management how developments are being tracked and addressed.

## Developments affecting financial reporting

Disclosure and transparency are again a major focus this year. The SEC issued disclosure requirements for non-GAAP measures in response to companies' growing use of these measures. And the SEC focused on the quality and clarity of financial statement and MD&A disclosures when it reported the results of its review of Fortune 500 companies' 2002 annual reports. On the accounting front, many hot topics from prior years continue to be front and center in rule making. Revenue recognition is one, with both the SEC—with an updated SAB—and the FASB—whose Emerging Issues Task Force issued guidance on recognizing revenue under multiple element revenue arrangements with deliveries in different accounting periods—weighing in. Another FASB project—on accounting for equity-based compensation—continues its closely scrutinized work on this controversial subject, in conjunction with international efforts. And the FASB project on business combinations continues, which promises significant impact on how business combinations will be accounted for, possibly changing the terms and economics of some deals being negotiated now. The FASB revisited some other complex issues this year, with new pronouncements on derivatives—clarifying their definition and fine-tuning the interpretation of scope exceptions—and on variable interest entities, another hot topic post-Enron. Finally, the FASB issued a standard that specifies that certain freestanding financial instruments must be classified as liabilities, with potentially significant impact on many companies. Audit committees will want to discuss with management and auditors how companies are complying with the new accounting and disclosure requirements, and keep up-to-date on evolving issues and their implications for the company.



# A brave new world for audit committees

At the start of 2003, observers hoped it would be the year the turmoil subsided. Revelations about Enron, WorldCom, and others were largely behind us. The Securities and Exchange Commission, as directed by the *Public Company Accounting Reform and Investor Protection Act of 2002*—commonly known as the Sarbanes-Oxley Act—and the stock exchanges were well down the road on rule making to restore public confidence in the markets. CEO and CFO certifications about the integrity of their companies' financial disclosures had been in place for a number of reporting periods. Indeed, the hope was that the scandals were safely behind us.

In hindsight that view was overly optimistic. Other major companies saw accounting crises fully erupt, and a host of former executives and employees plead guilty in connection with accounting fraud. Elsewhere, the investment banks settled charges about their business practices and then the mutual fund industry saw its own crises emerge. More work obviously is needed to restore public confidence.

So the world hasn't gotten any easier for investors, markets, or companies and the directors overseeing them. And audit committees have remained the focus of much of the board-level rule making, with many of the rules proposed during 2002 now finalized.<sup>1</sup>

## New membership drivers

### SEC rules on financial experts

In January 2003, as directed by Sarbanes-Oxley, the SEC adopted final rules for audit committee financial experts. See box for the final definition.

### SEC's definition of audit committee financial expert

A person who has the following attributes:

- An understanding of generally accepted accounting principles and financial statements;
- The ability to assess the general application of such principles in connection with the accounting for estimates, accruals, and reserves;
- Experience preparing, auditing, analyzing, or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities;
- An understanding of internal controls and procedures for financial reporting; and
- An understanding of audit committee functions.

Furthermore, a person must have acquired such attributes through any one or more of the following:

- Education and experience as a principal financial officer, principal accounting officer, controller, public accountant, or auditor, or experience in one or more positions involving the performance of similar functions

<sup>1</sup> The information and considerations presented herein are for general information only and do not constitute legal advice. Readers should refer to the actual text of the various statutes, provisions, rules, and regulations referenced throughout this document for specific language and consult with securities counsel regarding their specific facts and circumstances and any questions of compliance.

- Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor, or person performing similar functions
- Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing, or evaluation of financial statements
- Other relevant experience

Boards will apply the final definition and consider audit committee members' experience in determining which members, if any, qualify. Then, for fiscal years ending on or after July 15, 2003—December 15, 2003 for small business issuers—a company must disclose in its 10-K annual report that its board of directors has determined whether the company has at least one audit committee financial expert serving on its audit committee. If so, the company also must disclose the expert's name and whether he or she is independent of management. If not, the company must disclose this fact and explain why.

The final rules also provide a safe harbor to clarify that designating someone as an audit committee financial expert doesn't impose any duties, obligations, or liability that are greater than those of other audit committee members, nor does it affect the duties, obligations, or liability of other audit committee members who aren't so designated. Despite this safe harbor, some members who have been designated as experts have expressed concern about additional liability, and are reluctant to be named. Boards, however, don't have the option of not disclosing an audit committee financial expert if one is present.

Some audit committees have multiple members meeting the financial expert definition. The choice then becomes which member to name, or whether to disclose multiple experts' names. One plus to disclosing multiple experts is reassurance—letting shareholders know that if one expert leaves the committee, for whatever reason, there is bench strength and backup. Additionally, it avoids a possibly ticklish discussion about which expert to choose. But no amount of financial expertise on a committee can guarantee problem-free reporting.

### NYSE and NASDAQ financial competency rules

For its part, the New York Stock Exchange did not amend its "competency requirements" as part of its new rules. So, to recap:

- Each member of the audit committee must be financially literate, as the board interprets this qualification in its business judgment, or must become financially literate within a reasonable time after appointment to the committee.
- At least one member of the audit committee must have accounting or related financial management expertise, again, as the board interprets such qualification in its business judgment.

Although the criteria are different from those cited by the SEC, the NYSE notes a board may presume that if the audit committee has a member who meets the SEC's definition of financial expert, that person also meets the NYSE's definition of having accounting or related financial management expertise.

NASDAQ's "competency requirements" have changed; they no longer allow a person who doesn't already have basic financial literacy to be appointed to the audit committee. Now, the rules state:

- All audit committee members must be able to read and understand fundamental financial statements, including a company's balance sheet, income statement, and cash flow statement.
- At least one member of the audit committee must have past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background that results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer, or other senior officer with financial oversight responsibilities.

### SEC independence rules

In April 2003, again driven by Sarbanes-Oxley, the SEC adopted new independence restrictions for audit committee members of listed companies. With some exceptions, listed companies must comply by the earlier of the first annual shareholders' meeting after January 15, 2004, or October 31, 2004. Foreign private issuers and small business issuers that are listed must comply by July 31, 2005. Special phase-in rules apply to companies undertaking initial public offerings.

The SEC rule states that an audit committee member of a listed company can't be considered independent if the person, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee:

- Accepts directly or indirectly any consulting, advisory, or other compensatory fee from the company or any subsidiary; or
- Is an affiliated person<sup>2</sup> of the issuer or any subsidiary thereof.

### NYSE and NASDAQ independence rules

Audit committee members of listed companies face additional new independence standards, as both the NYSE and NASDAQ require all audit committee members to meet their respective revised independence criteria, with compliance by the earlier of the first annual shareholders' meeting after January 15, 2004, or October 31, 2004, although different transition rules apply for classified boards. (NASDAQ allows one nonindependent director meeting certain criteria to serve on an audit committee under exceptional and limited circumstances—and any such arrangement must be disclosed.) The new independence definitions are shown in the box. However, the SEC rules prohibiting audit committee members from accepting any compensation other than related to their board service supersede any allowance for *de minimis* amounts of compensation allowed by the NYSE and NASDAQ rules that apply to other directors.

## Factors precluding director independence

### NYSE rules

A director would not be independent who:

- Is an employee or has an immediate family member who is an executive officer of the company, until three years after such employment relationship has ended
- Receives, or has an immediate family member who receives, more than \$100,000 per year in direct compensation from the company, other than director and committee fees and pension or other deferred compensation for prior service—provided it is not contingent in any way on continued service—until three years after ceasing to receive more than \$100,000 per year in such compensation
- Is or has an immediate family member who is affiliated with or employed in a professional capacity by a present or former internal or external auditor of the company, until three years after the end of the affiliation or the employment or auditing relationship
- Is or has an immediate family member who is employed as an executive officer of another company where any of the listed company's present executives serve on that company's compensation committee, until three years after the end of such service or the employment relationship
- Is an executive officer or an employee, or whose immediate family member is an executive officer, of a company that makes payments to, or receives payments from, the listed company for property or services which, in any single fiscal year, exceed the greater of \$1 million, or 2% of such other company's consolidated gross revenues, until three years after falling below such threshold

### NASDAQ rules

A director would not be considered independent who:

- Is, or during the past three years was, employed by the company or by any parent or subsidiary

<sup>2</sup> A person "affiliated" with a specified person, means "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified." "Control" means "the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise."

## NASDAQ rules (continued)

- Accepts or who has a family member who accepts any payments from the company or any parent or subsidiary in excess of \$60,000 during the current or any of the past three fiscal years, other than:
  - compensation for board or committee service
  - payments arising solely from investments in the company's securities
  - compensation paid to a family member who is a nonexecutive employee of the company or a parent or subsidiary
  - benefits under a tax-qualified retirement plan, or nondiscretionary compensation
  - permitted loans
- Is a family member of an executive officer of the company or any parent or subsidiary, or was during the past three years
- Is or has a family member who is a partner in, or a controlling shareholder or an executive officer of, any organization to which the company made, or from which the company received, payments for property or services (except arising solely from investments in the company's securities) that exceed 5% of the recipient's consolidated gross revenues for the year, or \$200,000, whichever is more, in the current or any of the past three fiscal years
- Is or has a family member who is employed as an executive officer of another entity where any of the executive officers of the listed company serve on the compensation committee, or if such relationship existed during the past three years
- Is or has a family member who is a current partner of the company's outside auditor, or was a partner or employee of the company's outside auditor, and worked on the company's audit during the past three years

In addition to the specific definitions, both the NYSE and NASDAQ set out overall rules for determining director independence. The NYSE rules specify a director isn't independent unless the board affirmatively determines there is no material relationship with the company—either directly or through another company for which the director serves in one or more specified capacities. Companies then must disclose these determinations. According to NASDAQ, a director would not be independent if there's a relationship that, in the board's opinion, would interfere with the exercise of independent judgment in carrying out directors' responsibilities.

There was a great deal of attention paid, post-Enron, to whether charitable contributions the company makes to an organization a director is affiliated with taint that director's independence. Both the NYSE and NASDAQ considered the issue in their rule making.

The NYSE doesn't consider payments to charitable organizations as impeding independence, provided the company discloses in its annual proxy statement any contributions to any charitable organization in which a director serves as an executive officer, if such contributions in any single year within the preceding three years exceeded the greater of \$1 million or 2% of the organization's consolidated gross revenues.

For its part, NASDAQ permits payments under nondiscretionary charitable contribution matching programs. However, director independence would be impaired by significant discretionary payments—5% of the charity's revenues for the year or \$200,000, whichever is more—to a charitable organization for which a director or a director's family member is an executive officer.

The American Stock Exchange also amended its listing standards, with similar provisions pertaining to audit committee member financial competency and independence.

## New Sarbanes-Oxley driven responsibilities and authorities

The Sarbanes-Oxley Act required the SEC to direct stock exchanges to prohibit the listing of companies unless their audit committees take on specific new responsibilities for external auditors and complaint processes. Generally, companies must comply by the date of their first annual shareholders' meeting after January 15, 2004, but in any event no later than October 31, 2004; foreign private issuers and small business issuers have until July 31, 2005 to comply.

### Overseeing external auditors

The audit committee is directly responsible for appointing, compensating, retaining, and overseeing the work of the external auditors—including resolving disagreements between management and the auditors regarding financial reporting—and the external auditors must report directly to the audit committee.

Thus, the external auditors–audit committee relationship moves well beyond the prior listing markets' standard of simply having the auditors be “ultimately” accountable to the audit committee and the board. This change has many implications. One is a shift in the relationship dynamics among audit committees, external auditors, and management teams, away from what these parties have been accustomed to. As so often happens, change can cause unfamiliarity and discomfort. But savvy committee chairs are embracing the new responsibilities and, in close consultation with the external auditors and management, are taking a fresh look at a host of meeting dynamics—including agenda setting and information flow—and making changes when necessary or desired. Proactive audit committee chairs also are forcefully reaching out to audit engagement leaders, ensuring they build a relationship so the engagement leader knows with certainty where the key reporting relationship lies.

Although not required, audit committee chairs (and sometimes other members) increasingly are signing—or at least reviewing before management signs—the external auditors' engagement letter.

Additionally, as part of their oversight some committees are moving more forcefully into evaluating the external auditors' performance. How should audit committees do this? Some considerations:

- Discuss in private sessions with senior finance management and the internal audit director their views on the engagement team, including the competence, technical and industry knowledge, and service provided by the team and engagement leader
- Discuss among themselves their own views on the auditors' performance, based partly on contact with other audit firms gained from serving on other audit committees
- Request that management summarize feedback and other ranking information (from accounting industry observers, media, etc.) on the accounting firm's relative depth of practice, particularly in relation to the company's industry
- Discuss with the lead engagement partner and/or other firm representatives feedback, issues, and opportunities for further improvements

The box shows factors the committee may consider when assessing both the audit firm and the engagement partner(s). If the committee needs to select a new audit firm, it could apply many of the same factors to assist in its decision.

## Considerations in assessing external auditors

- The accounting firm's knowledge and experience in the company's industry
- The engagement team's overall business acumen and knowledge and experience in the company's industry
- The lead partner's overall business acumen, knowledge and experience in the company's industry, and his or her personal credentials
- The auditors' ability to clearly, candidly, and effectively communicate issues and concerns to the committee—both in private sessions and during meetings
- The committee's ability to build a trusting relationship with the lead partner, and its level of comfort with periodic contact between meetings
- The auditors' ability to work cooperatively with management—including the CEO and nonfinancial management—while maintaining objectivity; the sense the committee has of whether the lead partner has the “backbone” to stand up to management in difficult situations
- The auditors' ability to meet deadlines and respond in a timely way in providing service or responding to issues
- The lead partner's willingness to consult internally on issues, and his or her ability to leverage other firm resources, as needed
- The accounting firm's quality control procedures
- Significant findings from recent firm inspections, peer reviews, or other governmental oversight reviews, if publicly available
- The auditors' independence, and the systems employed to ensure independence
- The scope of the accounting firm's international network, if the company has international operations

### Establishing complaint processes

The audit committee must establish procedures for the receipt, retention, and treatment of any complaints regarding accounting, internal accounting controls, or auditing matters—including procedures for employees' confidential, anonymous submissions. Commonly termed “whistleblower” provisions, these new rules may well end up requiring as much, if not more, effort on the part of some audit committees as any other new audit committee responsibilities driven by Sarbanes-Oxley. Remember, in some of the major recent scandals, internal staff voiced concerns. But management proved adept at suppressing or allaying concerns, at least for a period. Thus, requiring audit committees to have direct involvement in this area increases the probability of getting more “sunlight” and constructive discussion and follow-up around known, suspected, or possible improprieties.

See Appendix A for further discussion of how audit committees can comply with these new rules and factors they should consider in establishing or improving complaint processes.

### Additional authorities

Sarbanes-Oxley recognized audit committees may need help. Accordingly, they have explicit authority to engage independent counsel and other outside advisors, as they determine necessary—and to have the company provide appropriate funding for such advisors as well as for the external auditors.

One question arising from such new authority is whether the audit committee should retain its own accounting advisor. In some instances, the needs of the audit committee can be met working with its external auditors. In others, for example, when significant matters arise that possibly bear upon past work performed by the external auditors or could place the

external auditors in an impermissible position of advocacy for the company, it may be desirable— if not required—to retain a separate accounting advisor or investigator.

### Preapproving services by the auditor

SEC rules require all registrants' audit committees to preapprove all audit and permitted nonaudit services provided by the external auditors to the company or its subsidiaries. The rule became effective May 6, 2003; services already underway or covered by contracts at that date are excluded from preapproval and are allowed to continue for up to 12 months thereafter—as long as they are not materially modified.

Audit committees have various options in complying. They can:

- Approve specific audit or nonaudit services prior to engaging the external auditors.
- Establish preapproval policies and procedures. Such policies and procedures must detail the particular service, provide for the audit committee to be informed of each service, and not delegate the committee's responsibilities to management.
- Use a combination of the above approaches.

Furthermore, preapproval can be delegated to an audit committee member(s), provided the designated member's decisions are reported to the full committee at subsequent meetings.

Recognizing that business conditions change and require flexibility, many committees have adopted the "combination" option. So how does this work in practice? One approach establishes categories of services—for example, annual audit and quarterly reviews; preparation and/or review of tax returns (including sales and use tax, excise tax, income tax, and property tax); consultation regarding handling of items for tax returns, required disclosures, elections, and filing positions available to the company; and assistance in financial due diligence, including review of financial statements, data, and records, and discussion with target's finance and accounting personnel—that auditors typically or are expected to provide. The committee approves these services periodically, say, annually. Then quarterly, the committee reviews the fees incurred for each category. But the SEC makes it clear that preapproval policies and procedures must be detailed as to the particular services to be provided, and using broad, categorical approvals—for example, tax compliance services—is insufficient. Any permitted services not falling into a preapproved service category are identified for preapproval by the committee (or a designated member) on a service-by-service basis and approved by the entire committee at its next meeting.

An alternative approach is to have the audit committee approve an established annual budget for each category of service (with requisite specificity) the external auditors are expected to provide. The auditors then execute these approved services. Services not outlined as part of the original budget are subject to case-by-case preapproval. At quarterly meetings, the committee reviews the amounts spent within each category and for additional services.

Each audit committee needs to agree upon a preapproval process and develop workable detailed policies and procedures to implement the process. See box for a list of typical elements in a preapproval policy.

## Elements of a preapproval policy

- Statement of principles
- Delegation to a single audit committee member
- Description of services
  - Clearly acceptable services for the auditor to provide—e.g., audit, review, and attest services
  - Clearly unacceptable services for the auditor to provide—e.g., those services specifically prohibited by the SEC as impairing auditor independence
  - Typical nonaudit services the committee has assessed and generally expects to find acceptable—e.g., specific tax services
  - Nonaudit services for which the committee's judgment is required
- Considerations about fee levels
- Procedures
- Forms to collect data relating to preapproval

The rules also provide a *de minimis* exception, but only for nonaudit services. In practice, this exception should rarely be used.

The discussion thus far has outlined processes and policies, but there's been little talk about how committees make their approval decisions. Crucially, committees need to understand the nature of nonaudit services proposed and consider the potential impact on auditor independence. In doing so, astute committees look particularly for services that don't impair independence, yet add valuable skills and knowledge that the audit engagement team can leverage for a more effective audit. Secondly, committees consider the efficiencies to be gained if the audit firm can apply its company knowledge to reduce its learning curve and save management time. And committees have approved the provision of nonaudit or advisory services by audit firms that have demonstrated to management a particular or distinctive competency expected to bring value to the company. But committees also are considering the optics, and some are choosing to restrict valid and allowable nonaudit services—even though committees don't believe they cause independence problems—simply in response to investor sensitivities in this area.

Finally, the new rules call for related disclosures in the company's proxy statement. The company must disclose the audit committee's preapproval policies and procedures—either providing a clear description or including a copy of them in the proxy. The company must disclose the fees paid to the external auditors in four categories: audit fees, audit-related fees, tax fees, and all other fees. And if the *de minimis* exception was applied, companies are required to disclose the percent of fees paid to the external auditors subject to the *de minimis* exception, again by category.

### New auditor communications

Generally accepted auditing standards require auditors to communicate a range of specific information to audit committees. The new auditor independence rules—described in detail in *Evolving Rules for Auditors*—add to this list, requiring auditors to report a number of other items to audit committees.

**All critical accounting policies and practices.** The SEC rules, which refer to SEC guidance on this topic from 2001, clarify:

- Critical accounting policies are those most important to portraying the company's financial condition and results, and require management's most difficult, subjective, or complex judgments—often as a result of the need to make estimates about the effect of uncertain matters.
- The discussion should include the reasons critical accounting estimates or initial accounting policies selected are or are not considered critical, and how current and anticipated future events may impact those determinations.

- Auditors can be expected to report their assessment of management’s disclosures and any significant modifications they proposed that weren’t included.

**Alternative accounting treatments.** Auditors are to communicate—orally or in writing—all alternative treatments within GAAP for policies relating to material items discussed with management. This includes the ramifications of using such alternative treatments and disclosures, and the auditors’ preferred treatment. It also includes information about specific transactions.

**Other material written communications.** Auditors will provide audit committees with copies of important documents provided to management. Some examples:

- Management representation letters
- Reports on internal control observations and recommendations
- Schedules of unadjusted audit differences, and a listing of adjustments and reclassifications not recorded, if any
- Engagement letters
- Independence letters

In terms of timing, these communications are to take place at least annually—before the annual report is filed with the SEC. But the SEC expects these discussions will take place more frequently—quarterly or even more often on a real-time basis as issues arise, initial accounting policies are adopted, or critical accounting policies change. Also, such communications must take place each time the auditors’ report is filed with the SEC, such as when auditors provide a consent.

## Additional responsibilities of NYSE and NASDAQ audit committees

In November 2003, the SEC approved amended NYSE listing standards pertaining to responsibilities for audit committees—first proposed in mid-2002. The new rules require specific items to be noted in charters.

### Audit committee charter requirements

The written charter must address:

- (i) The committee’s purpose, which at a minimum must be to:
  - Assist board oversight of:
    - the integrity of the company’s financial statements
    - the company’s compliance with legal and regulatory requirements
    - the external auditors’ qualifications and independence
    - the performance of the company’s internal audit function and external auditors
  - Prepare an audit committee report as required by the SEC to be included in the company’s annual proxy statement.
- (ii) An annual performance evaluation of the committee.

## Audit committee charter requirements (continued)

- (iii) The committee's duties and responsibilities, which at a minimum must include those set out under SEC rules, as well as the following:
- At least annually, obtain and review a report by the external auditors describing the firm's internal quality control procedures; any material issues raised by the most recent internal quality control or peer review of the firm, or by any inquiry or investigation by governmental or professional authorities within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with such issues; and (to assess the auditors' independence) all relationships between the external auditors and the company
  - Discuss the annual audited financial statements and quarterly financial statements with management and the external auditors, including MD&A disclosures
  - Discuss the earnings press releases, as well as financial information and earnings guidance provided to analysts and rating agencies
  - Discuss policies with respect to risk assessment and risk management
  - Meet separately, periodically, with management, with the internal auditors (or those responsible for the function), and with the external auditors
  - Review with the external auditors any audit problems or difficulties and management's response
  - Set clear hiring policies for employees or former employees of the external auditors
  - Report regularly to the board of directors

The newly stated purpose of the committee may drive other responsibilities. For instance, the aspect involving oversight of legal and regulatory compliance strongly suggests committees will need to capture related responsibilities in their charters—perhaps through activities such as periodic discussions with the chief compliance officer and general counsel, and reviewing with management significant issues raised by regulators and any corrective actions undertaken.

Committee charters need to be updated for these new responsibilities by the date of the first annual shareholders' meeting after January 15, 2004, but no later than October 31, 2004. Indeed, many audit committees have not waited. Starting in 2002, many committees began updating their charters to capture some or many of the emerging requirements, well in advance of compliance deadlines. The savvy committees, though, ensured they updated charters only when confident of their ability and capacity to carry out their responsibilities effectively. Many also started posting updated charters on company websites, also in early compliance with proposed rules.

The more fundamental challenge, though, is how audit committees will ensure they properly discharge all these new responsibilities. How do audit committees diminish the risk of noncompliance? Many create a robust meeting planner, mapping the responsibilities to meetings scheduled throughout the year. Then, the planner forms the basis for draft agendas for individual meetings, with additional items added as appropriate. At year end, the committee also reviews its charter and considers whether it's satisfied it has discharged its responsibilities appropriately, and undertakes any actions needed.

The process for covering all charter responsibilities doesn't mask the very real issue of committee overload. The new NYSE rules significantly expand responsibilities for many committees, and concern many because of their scope. One danger is committees taking a checklist approach to these responsibilities—having discussions that in form appear adequate, but don't address substance. Prudent committee members will ensure they have the time and environment for substantive discussions, even insisting on additional or longer meetings if the current timetable is inadequate.

For audit committees of NASDAQ companies, charters now must state the committee's purpose of overseeing the accounting and financial reporting processes and financial statement audits. But beyond that and the Sarbanes-Oxley driven

responsibilities, the only other new role relates to approving all related party transactions, and that can be done by either the audit committee or another independent body of the board.

A September 2003 survey of 48 large PricewaterhouseCoopers clients, with average revenues of \$18 billion, found:

- 94% already had revised their audit committee charter as a result of Sarbanes-Oxley or proposed stock exchange listing standards
- 81% had implemented a “whistleblower” or complaint process as called for by Sarbanes-Oxley
- 50% had performed a self-assessment of the audit committee in the previous year
- 46% already had changed audit committee composition post-Enron
- 85% hold more frequent audit committee meetings and 83% hold longer meetings post-Enron

It’s interesting to note that the first three—charter amendments, whistleblower processes, and self-assessments—represent early adoption of emerging rules. Holding longer and more frequent meetings also points to audit committees’ decision to make substantive commitments to involvement and activity, factors that many attorneys cite as providing among the best protection against legal liability.

## New focus on internal control

In June 2003, the SEC issued final rules for management’s reporting on internal control, as required by Sarbanes-Oxley Section 404.<sup>3</sup> The rules take effect for fiscal years ending on or after June 15, 2004 for companies qualifying as “accelerated filers” and for fiscal years ending on or after April 15, 2005 for other companies—small business filers and foreign issuers—unless the implementation timeline changes. Under the final rules, management’s report on internal control over financial reporting, included in the annual report, will include:

- A statement of management’s responsibility for establishing and maintaining adequate internal control over financial reporting
- A statement identifying the framework used by management to evaluate the effectiveness of internal control over financial reporting
- Management’s assessment of the effectiveness of internal control over financial reporting as of the end of the most recent fiscal year
- A statement that the external auditors who audited the financial statements have issued an attestation report on management’s assessment

Any material weakness in internal control over financial reporting that exists at the end of a company’s fiscal year and is identified, must be disclosed in management’s report. And if one or more material weaknesses exist, management is prohibited from concluding that internal control over financial reporting is effective. The emerging rules for auditor involvement in 404 reports are summarized in *Evolving Rules for Auditors*.

Going forward, companies also will have to evaluate and disclose any change in internal control over financial reporting during a fiscal quarter that has materially affected, or is reasonably likely to materially affect, the company’s internal control over financial reporting.

<sup>3</sup> See PricewaterhouseCoopers’ briefing paper *Management’s Responsibility for Assessing the Effectiveness of Internal Control Over Financial Reporting Under Section 404 of the Sarbanes-Oxley Act*, available at [www.pwc.com/uscorporategovernance](http://www.pwc.com/uscorporategovernance) and [www.cfodirect.com](http://www.cfodirect.com).

# What is internal control over financial reporting?

The process to provide reasonable assurance that financial reporting is reliable and financial statements for external purposes are prepared in accordance with generally accepted accounting principles (GAAP). Internal control over financial reporting includes policies and procedures to:

- Ensure records are maintained in reasonable detail and accurately and fairly reflect the company's transactions and dispositions of its assets
- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with GAAP, and that receipts and expenditures are made only in accordance with management and board authorizations
- Provide reasonable assurance that unauthorized acquisition, use, or disposition of company assets that could have a material effect on the financial statements is prevented or detected in a timely manner

But simply reading the statement that management will make, doesn't communicate the sheer volume of effort and resources required for compliance. The scope is enormous. Generally speaking, management's assessment extends to all significant account balances and disclosures, barring only those that, either individually or in the aggregate, couldn't result in a material misstatement. So management's first task is to identify all the balances and disclosures it needs to include in its report scope, related and relevant financial statement assertions, and significant processes and related accounting and control activities pertaining to classes of transactions that affect those accounts, disclosures, and assertions—looking across all of the company's operations and locations around the world.

Next, the rules require management to apply a recognized control framework, and cite the COSO framework<sup>4</sup> as one satisfying the criteria. Thus, management applying COSO must consider all five components of internal control:

- The control environment—Factors include integrity, ethical values, management's philosophy and operating style, assignment of authorities and responsibilities, and attention and direction provided by the board
- Risk assessment—Identification and analysis of relevant risks, from both external and internal sources, to the achievement of a company's objectives
- Control activities—Policies and procedures helping ensure risks are addressed and management's directives are carried out; include such activities as approvals, reconciliations, and segregation of duties
- Information and communication—Identifying, capturing, and communicating pertinent information so people can carry out their responsibilities and informed business decisions can be made
- Monitoring—Ensuring internal controls continue to function over time

So, for each significant account balance and disclosure, management must document both the design of related controls—covering all five COSO components—and the testing processes it applied. And, the documentation needs to provide reasonable support for the evaluation of whether internal control is designed to prevent or detect material misstatements or omissions, for the conclusion that tests were appropriately planned and performed, and that test results were appropriately considered in making the assertion.

## Leading practices for 404-preparedness

The size, complexity, and what's at stake surrounding 404 compliance are similar in many ways to companies' efforts undertaken for Year 2000. Some key points:

- Avoid denial and procrastination. Most large U.S.-based companies—some estimating 404 efforts will require over 40,000 person hours for first-year compliance—are working steadfastly toward compliance. Anecdotal evidence, however, suggests that some smaller companies and foreign issuers remain in denial and, as of late 2003, have yet to start work on 404. Despite deferred implementation timetables such companies enjoy, audit committees need to insist manage-

<sup>4</sup> COSO refers to the Committee of Sponsoring Organizations of the Treadway Commission, which released *Internal Control – Integrated Framework* in 1992.

ment drive the process, which is proving a bigger effort the further companies get into it. As the SEC Chief Accountant warned in December 2003, “Companies that decide to wait until it’s too late to prepare for these changes will ultimately regret that decision.”

- Ensure senior management support. Given the size of the efforts, companies are establishing Project Management Offices (PMOs) to develop compliance strategy, define the universe and scope, establish documentation standards, identify technology platforms, coordinate efforts among units, monitor status, and report to senior management and the audit committee. The PMO’s role as organizer and facilitator is vital to ensuring consistency and quality across the organization, and that deadlines are met. But the PMO itself cannot do all the work. The support of senior management and the audit committee is vital to ensure the availability of adequate resources and that dispersed management teams understand that compliance is mandatory, not discretionary.
- Involve external auditors. It’s management’s responsibility to establish, document, and test controls. It can’t delegate its assessment to the external auditors who must independently attest to management’s assertion. Auditor independence guidelines preclude external auditors from assuming management’s responsibilities or acting in the capacity of management, although auditors may provide some assistance—like helping to document current controls. Most importantly, management and external auditors need to establish a common understanding of their respective responsibilities, closely coordinate their respective activities, and communicate continually throughout the process. Indeed, the company needs to share, up front, key judgments made about which accounts and disclosures merit coverage, the extent of planned documentation, and the expected level of management testing. Management needs to ensure the auditors understand the planned scope of work early on, so any needed adjustments can be made to the approach on a timely basis.
- Anticipate additional work. Even well-run companies are finding surprises. They’re finding controls are informal in some instances and missing altogether in others. That doesn’t mean there were reporting problems, but that not all components of internal control were factored into the original design. And the more companies accomplish, the bigger they are realizing their task is.

So, there’s a great deal of work, cost, and effort involved. Broadly speaking, it’s hoped these efforts will restore public confidence in the capital markets. Perhaps we’ll never be able to demonstrate that 404 evaluations and attestations prevent accounting scandals—it’s difficult to measure what doesn’t happen. But some companies are mining 404 efforts for added benefits. Some are using this exercise as an opportunity to standardize policies and processes across business units—thereby gaining efficiencies. Others are finding benefit in having more individuals within the company understand the breadth of the company’s policies and operations. In some cases, information being uncovered is prompting changes to contractual relationships—better serving and protecting the company. Still others are using judgments that particular business units are insignificant to spur a strategic reconsideration of their business mix. Indeed, even a handful of private companies are implementing significant elements of 404 documentation and management testing, as they see the value in a fresh look at internal control.

What should audit committees do? Understand the overall approach management is taking, who the players are, and the extent of the external auditors’ involvement. Be comfortable that progress is being made, and that participants recognize the importance of the situation. If the PMO is not getting the cooperation it needs, or if key milestones are being missed, reinforce the tone at the top by requiring the “laggards” to meet with the committee or committee chair and provide their commitment to the effort. As the project components are completed, discuss with management any control issues, their implications for current disclosure requirements (e.g., Sarbanes-Oxley Section 302), how control issues will be resolved, and management’s testing plans. Discuss with management the results of any “dry run” completed. And, as described below, ensure the committee itself is playing an appropriate role in overseeing the adequacy of internal control over financial reporting. And as with the Year 2000 issue, every audit committee meeting should address the status as an agenda topic.

The focus on internal control continues to evolve. Appendix B summarizes new guidance for enterprise risk management.

## Assessing audit committee performance

As covered above, new NYSE rules—and leading practice, generally—require an annual assessment of the audit committee’s performance. But the assessment doesn’t stop there.

Sarbanes-Oxley established the Public Company Accounting Oversight Board (PCAOB) to register, inspect, and investigate and discipline firms auditing SEC registrants, and to adopt auditing, quality control, ethics, independence, and other standards relating to the preparation of audit reports. In the standard-setting arena, a proposed standard on audits of internal control over financial reporting was issued for public comment in October 2003.

The PCAOB proposes to require external auditors to evaluate factors related to the effectiveness of the audit committee's oversight of the company's external financial reporting and internal control over financial reporting. Why? Because the committee plays an important role in the control environment—through setting a positive tone at the top and through monitoring internal control over financial reporting. The box shows the factors the PCAOB proposes external auditors consider in their assessment. At the earliest, such assessments will be made for fiscal years ending on or after June 15, 2004 for accelerated filers and for fiscal years ending on or after April 15, 2005 for other companies, including foreign issuers, unless the implementation timeline changes.

And if the auditors determine the committee's oversight is ineffective, the PCAOB proposal indicates that finding should be regarded at least as a significant deficiency and as a strong indicator of a material weakness.

## Factors relating to audit committee effectiveness

- Audit committee members' independence from management, including how they're nominated and selected, and whether they act independently from management
- Clarity of the committee's responsibilities and how well the committee and management understand them
- Level of involvement and interaction with external auditors, including appointment, retention, and compensation role
- Level of involvement and interaction with internal audit, including line of authority and role in appointing and compensating employees in the internal audit function
- Committee's compliance with applicable listing standards adopted pursuant to Sarbanes-Oxley
- Whether the committee includes one or more "audit committee financial experts"
- Amount of time the audit committee devotes to control issues and committee activity

It's important to note that not all observers agree with the concept of having auditors evaluate audit committee effectiveness factors, and have expressed such concerns through the comment process. Additionally, some in the auditing profession have concerns about the context for the proposed work. They believe the evaluation of the audit committee's effectiveness should be undertaken in the context of the auditor's evaluation of a company's overall control environment, which includes other governance activities and considerations.

So what should committees be doing? First, even if a committee is not required to evaluate its performance, it's a leading practice to consider its effectiveness in overseeing internal control over financial reporting and in discharging its other responsibilities. It can leverage the factors described in the box, and incorporate any additional factors once a final standard is issued. The committee needs to be candid if there are any questions as to the adequacy of its practices or concerns about members. It needs to identify any resulting changes required, report issues and plans to the board, and establish an action plan and timeframes to effect change.

And committees should undertake such evaluations and discussions sooner, not later. Why? Because, to the extent membership changes are needed, it can take time to find qualified replacements. It also takes time to implement new processes and educate committee members if the perceived needs involve oversight of financial reporting matters and controls.

## Coping with accelerated filing

Companies subject to the SEC's accelerated filing rules<sup>5</sup> are now seeing the rules' impact hit home. The Form 10-K annual report deadline drops from 90 to 75 days, for years ending on or after December 15, 2003, and for companies with calendar year ends, the first quarter of 2004 will see the quarterly report deadline drop to 40 days from 45. And the timeframes will tighten further in the subsequent year.

What does this mean for audit committees? For one thing, it may mean a change in scheduling of meetings and calls to discuss quarterly results, and review 10-Ks and 10-Qs, thus moving the timing closer to quarter end. And for those who sit on multiple calendar-year-end companies' audit committees, it may result in a packed and intense schedule following quarter ends. Accordingly, committee members in such situations may well reassess the number of audit committees they serve on, which aligns with the NYSE's expressed caution and related disclosure requirements in instances when audit committee members serve on more than three public company audit committees.

## Commission on Public Trust and Private Enterprise—audit and accounting

In February 2002, the Conference Board established the Commission on Public Trust and Private Enterprise to address the widespread abuses that led to the corporate scandals and declining public trust in companies, management, and America's capital markets. The Commission's mandate was to examine compensation, auditing, and governance issues facing corporate America and issue a series of best practices guidelines.

In September 2002, the Commission issued its first report, on executive compensation.<sup>6</sup> In January 2003, it issued the final two parts on corporate governance and audit and accounting. The corporate governance portion of the report is summarized in *Continuing Focus on Boards*. The box summarizes the principles the Commission recommends for audit and accounting.

### Audit and accounting principles

#### 1. The enhanced role of the audit committee

Audit committees should be vigorous in complying with the numerous new requirements imposed by Sarbanes-Oxley and the SEC, and by the stock exchanges.

#### 2. Audit committee education

Each member of the audit committee should participate in an orientation program and in regular continuing education programs.

#### 3. Improving internal controls and internal auditing

Public companies should revise their internal controls to reflect a broad risk-based approach and to support the certification process for both financial reports and internal controls.

#### 4. Auditor rotation

Audit committees should consider rotating audit firms if circumstances call into question the audit firm's independence from management.

<sup>5</sup> See full description in *Current Developments for Audit Committees 2003*, available at [www.pwc.com/uscorporategovernance](http://www.pwc.com/uscorporategovernance).

<sup>6</sup> This report is summarized in Appendix B of *Current Developments for Audit Committees 2003*, available at [www.pwc.com/uscorporategovernance](http://www.pwc.com/uscorporategovernance).

## Audit and accounting principles (continued)

### 5. Professional advisors for the audit committee

The audit committee should, if necessary, retain professional advisors with no other ties to the company to assist it in carrying out its functions.

### 6. Services performed by accounting firms

Public accounting firms should limit their services to clients to performing audits and to providing closely related services that do not put the auditor in an advocacy position.

### 7. The business model of accounting firms

The leadership of the major accounting firms should ensure their business model is consistent with the idea that quality audits are their number one priority.

Some of the related best practices suggested by the Commission include:

- Boards shouldn't underestimate the new requirements for audit committees and should ensure sufficient resources are devoted to implement them.
- All companies should have an internal audit function—with a direct line of communication and reporting responsibility to the audit committee—with audit plans that center on the company's risks and vulnerabilities.
- The internal auditor should attend all regularly scheduled audit committee meetings, report on the status of audits conducted and any other matters that should be brought to the committee's attention, and meet with the audit committee in executive session.
- Every public company board, and especially the audit committee, should make enterprise risk assessment and internal controls high priorities in order to facilitate the certification and reporting processes required by Sarbanes-Oxley Sections 302 and 404.
- Although audit committees should evaluate their current audit firm at least annually, the committee also should perform a more thorough evaluation and review at least every five to seven years.
- The primary emphasis in choosing an audit firm should be the demonstrated experience, quality, and depth of knowledge of all audit personnel to be assigned to the audit, specific industry expertise, the scope of work to be performed, and any inspection reports available about the audit firm. The committee should ensure the audit fees do not negatively affect the scope of work necessary for the auditors to perform a quality audit.

## Impact on audit committees

Audit committees coped with unprecedented change over the past year, and many took forceful action to respond; indeed, many already are complying with the plethora of new rules in advance of required dates. But to the extent audit committees have waited for the final NYSE and NASDAQ rules before updating charters and procedures, they will want to turn attention immediately to charter updates and related new processes. And as all committees start to address new responsibilities, they'll want to periodically assess whether they are meeting frequently enough and for sufficient time to fulfill their responsibilities effectively.

Regardless of whether the PCAOB's final auditing standard pertaining to 404 attestation reports explicitly calls for the external auditor to evaluate audit committees' effectiveness, audit committees should evaluate periodically whether they are effectively performing their oversight role, including staying focused on overseeing external financial reporting and internal control over financial reporting. In performing this evaluation, committees may wish to look at some of the same factors enumerated in the PCAOB's proposed auditing standard. And they may wish to link this assessment with the broader assessment that many committees will be performing under the new NYSE rules.

Despite changes already implemented, audit committees' work is by no means done. Over the upcoming year, they'll pay close attention as Sarbanes-Oxley 404 assessment work picks up steam, and will want to quickly address any findings of concern that arise. They'll recognize that significant effort and resources will be needed for Section 404 compliance, and will monitor status closely. They'll also oversee the first wave of accelerated filing deadlines, which may challenge some management teams. All in all, it portends to be a challenging year.

Fortunately, audit committees can draw on a number of resources for support and information, including publications such as this one. Numerous organizations, conferences, and "colleges" provide training for audit committee members. Additionally, the American Institute of Certified Public Accountants (AICPA) has issued a new Audit Committee Toolkit to support audit committee members in fulfilling their evolving responsibilities. Of interest to committees seeking to recruit new members, the AICPA also has established a database with names and profiles of CPAs who are interested in serving on audit committees. Companies may search the database for individuals who match their needs. Both can be found at [www.aicpa.org/audcommctr](http://www.aicpa.org/audcommctr).



# Continuing focus on boards

## New NYSE listing standards affecting boards

The New York Stock Exchange proposed significant new rules for boards in 2002, which the SEC ultimately approved in November 2003. Generally, listed companies that are subject to the rules will have to comply by the earlier of their first annual meeting after January 15, 2004, or October 31, 2004. Other phase-in periods apply to companies making an initial public offering.

### Board independence

The new rules require boards of NYSE-listed companies to have a majority of independent directors. The rules provide factors—described in *A Brave New World for Audit Committees*—for boards to apply when making their independence determinations. And the company must disclose the determinations the board is required to make in affirming that a director qualifies as “independent”—that is, has no material relationship with the listed company, either directly or as a partner, shareholder, or officer of an organization that has a relationship with the company.

The factors in the new independence definition reference a three-year, “look-back” period. Given the tight timeframe between when the rules were approved and when they take effect, the NYSE provides special transition provisions. Thus, the rules phase in the look-back provisions by applying only a one-year look back for the first year. The three-year look backs will begin to apply November 4, 2004.

### Executive sessions for nonmanagement directors

To empower nonmanagement directors to serve as a more effective check on management, they must meet in regularly scheduled executive sessions without management. And since the population of nonmanagement directors may include directors who are not “independent,” the NYSE suggests that at least once a year the executive session be restricted to only independent directors.

Companies are to disclose in their proxy statements the director who presides over these executive sessions or the procedures used to select a presiding director for each session. Additionally, companies must disclose how interested parties can communicate concerns directly to the presiding director of the executive sessions, or to the nonmanagement directors as a group. Companies may, if they wish, leverage the same “whistleblower” procedures established to comply with the Sarbanes-Oxley requirements concerning complaints.

### Nominating/corporate governance and compensation committees

The rules require both nominating/corporate governance and compensation committees to be established, each with a written charter and each composed entirely of independent directors. The committees’ written charters, which are to be posted on the company’s website, must address certain items, as shown in the box.

# Required charter contents

## Nominating/corporate governance committee

- The committee's purpose and responsibilities:
  - To identify individuals qualified for board membership, consistent with board-approved criteria
  - To select (or recommend to the board) director nominees for the next annual shareholders' meeting
  - To develop and recommend to the board a set of corporate governance principles
  - To oversee the evaluation of the board and management
- Annual performance evaluation of the committee

### *Also recommended:*

- Committee member qualifications
- Committee member appointment and removal procedures
- Committee structure and operations
- Reporting to the board
- Sole authority to retain and terminate any search firm used to identify director candidates

## Compensation committee

- The committee's purpose and responsibilities:
  - To review and approve corporate goals and objectives relevant to CEO compensation, evaluate the CEO's performance, and determine and approve (either as a committee or with other independent directors) CEO's compensation
  - To make recommendations to the board on non-CEO compensation, incentive-compensation plans, and equity-based plans
  - To produce the compensation committee report for the proxy statement
- Annual performance evaluation of the committee

### *Also recommended:*

- Committee member qualifications
- Committee member appointment and removal procedures
- Committee structure and operations
- Reporting to the board
- Sole authority to retain and terminate compensation consultants

## Corporate governance guidelines

The rules further require companies to adopt and publicly disclose on their website corporate governance guidelines, as well as reference the website availability of these guidelines and key committee charters in their annual reports. At a minimum, the guidelines must cover:

- Director qualification standards relating to independence—also may include policies limiting the number of boards on which a director serves, and director tenure, retirement, and succession
- Director responsibilities such as expectations for attendance at meetings and advance review of materials

- Director access to management and independent advisors, as necessary
- Director compensation such as determinations of its form and amount
- Director orientation and continuing education
- Management succession, such as principles for CEO selection and performance review, and policies for succession in the event of an emergency or CEO retirement
- Annual performance evaluation of the board, including whether committees are functioning effectively

The new NYSE rules touch on other corporate functions as well. They require each company to have an internal audit function. And they require companies to adopt and disclose a code of business conduct and ethics for directors, officers, and employees, and promptly disclose any waivers of the code for directors or executive officers. At a minimum, the code should cover<sup>7</sup>:

- Conflicts of interest. Prohibit conflicts of interest, and provide a means for communicating potential conflicts to the company.
- Corporate opportunities. Prohibit personally using corporate opportunities; using corporate property, information, or position for personal gain; and competing with the company.
- Confidentiality. Maintain the confidentiality of information entrusted to directors, officers, and employees by the company or its customers, except when disclosure is authorized or legally mandated.
- Fair dealing. Deal fairly with the company's customers, suppliers, competitors, and employees.
- Protection and proper use of company assets. Protect company assets and ensure their efficient, legitimate use.
- Compliance with laws, rules, and regulations (including insider trading laws). Promote compliance.
- Encouraging the reporting of any illegal or unethical behavior. Promote ethical behavior and encourage employees to discuss issues and report violations of laws, rules, regulations, or the code of business conduct to appropriate personnel.

Controlled companies (those with more than 50% of their voting power held by an individual, a group, or another company), foreign private issuers, limited partnerships, funds, and certain other companies are exempt from complying with specified provisions of the new NYSE rules.

In June 2003, the SEC approved another NYSE rule, which guarantees shareholders the opportunity to vote on all equity-compensation plans and material revisions thereto, with exemptions for employment inducement awards; certain grants, plans, and amendments in the context of mergers and acquisitions; and certain qualified plans. However, these exempt grants, plans, and amendments require the approval of the company's independent compensation committee or of a majority of the company's independent directors. Generally, this new rule applies to plans being adopted after the SEC approved the listing standard, with additional special transition dates and amendment considerations provided.

## New NASDAQ rules affecting boards

The SEC also approved NASDAQ's new rules for governance in November 2003. Generally, quoted companies will have to comply by the earlier of their first annual shareholders' meeting after January 15, 2004, or October 31, 2004. Companies with staggered boards have until their second annual meeting after January 15, 2004, but not later than December 31, 2005, to implement all new requirements relating to board composition. Foreign private issuers and small business issuers have to comply by July 31, 2005. Other implementation deadlines apply to IPO companies and those transferring between exchanges.

<sup>7</sup> For additional information about leading practices for codes of conduct, see Appendix A in *Current Developments for Audit Committees 2003*, available at [www.pwc.com/uscorporategovernance](http://www.pwc.com/uscorporategovernance).

**Independence.** The NASDAQ rules require a majority of independent directors on boards, and companies to disclose in their proxy statements which directors are considered independent. The rules define factors—described in *A Brave New World for Audit Committees*—that bar a director from being considered independent, and also point to a general principle that a director would not be independent if he or she had a relationship that, in the board’s opinion, would interfere with the exercise of independent judgment in carrying out directors’ responsibilities. Furthermore, the rules require regularly scheduled meetings at which only independent directors are present.

**Compensation decisions.** The NASDAQ rules require that either a majority of independent directors or a compensation committee composed solely of independent directors determine (or recommend to the board) compensation for the CEO and all other officers. There are limited exceptions—if the compensation committee is composed of at least three members, one could be a nonindependent director, as long as the person is not a company officer, employee, or family member of such person. This nonindependent director could serve a maximum of two years on the committee, and the board would have to disclose in the proxy statement why that person’s membership on the committee was in the best interests of the company and its shareholders.

**Nomination decisions.** Similarly, the NASDAQ rules require that either a majority of independent directors or a nominating committee composed solely of independent directors select (or recommend to the board) director nominees. Again, if the committee has at least three members, one can be a nonindependent director, if the board determines it’s in the best interests of the company and discloses the fact in the proxy statement. The nonindependent director’s committee membership is likewise limited to two years. Further, NASDAQ requires companies to certify they have adopted a formal written charter or board resolution addressing the nomination process, but recognizes such nomination provisions don’t apply if a third party has a legal right to nominate a director or the company is bound to a preexisting nomination structure.

These board independence, nomination, and compensation rules do not apply to “controlled” companies, as defined above in the section on new NYSE rules. But those companies will have to disclose in their annual proxy statement that they are relying on the controlled company exemption. And regularly scheduled meetings at which only independent directors are present will still have to be held.

The new NASDAQ rules also require companies to adopt a code of conduct for all directors, officers, and employees, and to make the code publicly available. In addition to complying with Sarbanes-Oxley requirements, the code must provide an enforcement mechanism to ensure prompt and consistent enforcement of the code, protection for people reporting questionable behavior, clear and objective standards for compliance, and a fair process by which to determine violations. The board must approve any waivers for directors or executive officers, and these must be publicly disclosed within five days.

And, to the extent the audit committee doesn’t do so, some independent body of the board must approve all related party transactions.

## Nominating committee disclosures and board communication channels

In November 2003, the SEC adopted rules to enhance the transparency of board operations by expanding disclosure requirements about nominating committees and how, if at all, shareholders may communicate with directors. Companies must comply with these requirements in proxy statements to shareholders on or after January 1, 2004, and in the first quarterly or annual reporting period ending after January 1, 2004.

A great deal of new disclosure about a company’s nomination process is required. First, companies must state whether a nominating or similar committee exists. If not, the disclosure must indicate why the board believes such a committee is not warranted and identify which individual directors consider director nominees. The box summarizes additional disclosures required about the nomination process.

# Required director nomination process information

## Charter

- If the nominating committee has a charter, indicate whether a copy is available on the company's website and, if so, the website address. If the charter is not available on the website, include a copy in the proxy statement at least once every three fiscal years. And, if a copy isn't on the website, and isn't included in the proxy statement, identify which prior year's proxy included the charter.
- If the nominating committee has no charter, state that fact.

## Independence

- If the company is listed on an exchange that has independence requirements for nominating committee members, disclose whether the members of the nominating committee are independent, as defined in the listing standards.
- If the company is not listed, disclose whether each of the members of the nominating committee is independent, applying the definition of one of the national securities exchanges or associations consistently to all members, and stating which definition is used. The company must use the same independence definition it applies in considering audit committee member independence.

## Director candidates

- If the nominating committee has a policy for considering director candidates recommended by security holders, describe the material elements of that policy, including a statement as to whether the committee will consider director candidates recommended by security holders. Also describe procedures security holders should follow in submitting such recommendations.
- If the committee does not have a policy for considering director candidates recommended by security holders, state so and why the board believes that it is appropriate for the company not to have such a policy.
- Describe any specific, minimum qualifications that the committee believes must be met before it will recommend a nominee, and any specific qualities or skills necessary for one or more of the company's directors to possess.
- Describe the committee's process for identifying and evaluating nominees for director, and any differences in how the committee evaluates nominees recommended by a security holder.
- For each nominee the committee approves for inclusion on the proxy card—other than executive officer nominees or directors standing for reelection—state who recommended him or her: security holder, nonmanagement director, chief executive officer, other executive officer, third-party search firm, or other, specified source.
- If the company pays a fee to any third party or parties to identify or evaluate, or assist in identifying or evaluating, potential nominees, disclose the function performed by each such third party.
- For a nominee recommended by an individual or group of security holders that beneficially owned more than 5% of the company's voting common stock for at least one year as of the date the recommendation was made, identify the candidate and the recommending security holder or group and disclose whether the committee chose to nominate the candidate. Note that no such identification or disclosure is required without the written consent of both the security holder or group and the candidate.

The new rules also require disclosure regarding communications by security holders with directors. Companies will be required to:

- Disclose whether the board provides a process for security holders to send communications to the board and, if the company does not have such a process, a statement of the basis for the board's view that it is appropriate for the company not to have such a process.
- If the company has a process for security holders to send communications to the board of directors:

- Describe the manner in which security holders can send communications to the board and, if applicable, to specified individual directors.
- If all such communications are not sent directly to board members, describe the company's process for determining which communications will be relayed to board members.

In addition, the new rules require companies to describe their policy, if any, for board members' attendance at annual meetings and state how many board members attended the prior year's annual meeting.

With these rules, the SEC is taking a "comply or explain" approach, dovetailing with new rules from both the NYSE and NASDAQ focusing on independent director involvement with board nominees. But the SEC's rules go further in many respects, requiring additional disclosures about whether security holders can nominate candidates, the nomination process, and how nominees are evaluated.

And while the new NYSE rules require companies to disclose how interested parties can communicate concerns directly to the board level, the new SEC rules clearly establish the framework or means for non-NYSE registrants to provide similar communications channels.

## Determining executive compensation

One can't discuss governance developments affecting boards without touching on the delicate issue of executive compensation. Commentators repeat the figures like a mantra—a few decades ago, the average Fortune 500 CEO was paid 40 times the average employee's pay; today, it's 400 times. Add to that media reports on the lavish lifestyles of certain CEOs and the rich compensation and retirement packages some enjoyed—even those replaced during corporate scandals and implicated in wrongdoing—and the level of public mistrust is understandable. It's also prompting some observers to speculate that if boards don't rein in executive compensation, a "Sarbanes-Oxley 2" could do it for them.

So, how has corporate America responded? In September 2002, the Conference Board Commission on Public Trust and Private Enterprise issued its first report, on executive compensation.<sup>8</sup> It points to factors like independent director involvement in compensation decisions, and truly linking pay to performance. In December 2003, the National Association of Corporate Directors released the Report of the NACD Blue Ribbon Commission on Executive Compensation and the Role of the Compensation Committee. This report describes a set of principles and practices boards and compensation committees can apply in determining executive pay. Additionally, the new NYSE and NASDAQ rules ensuring independent director oversight of executive compensation reinforce the importance of independence. But without a change in mindset on the part of boards, without a willingness to engage in difficult negotiations with executives around compensation, without a willingness to buck the status quo, nothing will change. Note that critics don't have fundamental problems with boards paying well for superior performance—what they reject is the notion that boards continue to pay well for mediocre or dismal performance.

This space is too short to detail all practices compensation committees could consider to improve their effectiveness. But, given the reputational damage to American business from the scandals witnessed over the past few years, here are some first steps:

- The board should refuse to buy into the myth that a CEO will walk if the compensation committee doesn't meet all demands. Reality is there are few top jobs available—the market for CEO positions sees supply far outstripping demand. Another reality—unrecognized though it may be—is that as the company does with any supplier of a significant service, the board must negotiate with management to ensure the best deal for shareholders, and negotiate in the true sense of the word—but not in an antagonistic manner.
- The compensation committee should consider provisions in executive contracts and severance agreements to limit cash payments in the event of wrongdoing, and to require executives to return performance bonuses if evidence subsequently shows the bonuses were based on fraudulent results.

<sup>8</sup> This report is summarized in Appendix B of *Current Developments for Audit Committees 2003*, available at [www.pwc.com/uscorporategovernance](http://www.pwc.com/uscorporategovernance).

- The audit committee should discuss compensation plans with the compensation committee, focusing on the extent to which particularly lucrative incentives may encourage improper financial reporting practices or other behavior that goes near or over “the line.”
- Board governance guidelines should require a management director to tender his or her resignation from the board upon employment termination. This policy would avoid the bizarre theatre witnessed in recent years of boards’ inability to bar disgraced and terminated executives from the boardroom.

## Director compensation

For their part, directors are spending more time and effort on discharging their responsibilities, and are, many believe, facing additional liability—both issues of particular concern for audit committee members.

A September 2003 Management Barometer survey conducted for PricewaterhouseCoopers, with responses from 177 CFOs and senior executives of U.S. multinational companies, found:

- 62% indicated that over the past year their boards spent either “much more time” or “a little more time” than they had previously.
- When asked about how the scope of work and time spent by their audit committees had changed over the past year, 42% indicated the audit committee was spending “much more time,” with another 26% indicating “a little more time.”
- The 20% of respondents who indicated their boards’ total compensation had increased, reported an average increase of almost 18%, and 10% of respondents expect board compensation to increase in the year ahead, by an average 10%.
- The 22% of respondents who indicated their audit committees’ total compensation had increased, reported an average increase of almost 26%. Again, 10% of respondents expect audit committee compensation to increase in the year ahead, by an average of just under 10%.

So directors are busier, and some are getting or can expect raises. But for many directors, the pay is not what drives their board service. Indeed, for diligent directors and those working with companies in crisis, the compensation rewards can be insignificant compared with the time and effort they’re dedicating. So why is a focus on director compensation important? Partly because, philosophically, there should be a link between risk, effort, and compensation, and boards should periodically reexamine assumptions that factor into board fees. And partly because fees are one element director nominees weigh—along with considerations of perceived opportunities to add value, company reputation, and personal liability—when they’re being recruited for board service.

## Restoring trust—the WorldCom report

In August 2003, Richard Breeden, WorldCom’s Corporate Monitor, provided his 78 recommendations for reshaping its governance structures. The recommendations are intended to prevent recurrence of the governance abuses instrumental in WorldCom’s collapse—the United States’ largest bankruptcy. The 156-page report, which provides added background and reasoning behind the recommendations, is available at [www.nysd.uscourts.gov/rulings/02cv4963\\_082603.pdf](http://www.nysd.uscourts.gov/rulings/02cv4963_082603.pdf). The box summarizes the key areas and elements of the specific recommendations.

# Report recommendations

## 1. Board of directors

Board size, independence, separate independent sessions, meetings, director training, term limits, removal of directors, tender resignation upon change of employment status, limits on board memberships, skill base, nominations

## 2. Board leadership and chair

Nonexecutive chair responsibilities, nominations, qualifications, compensation, term limits, performance review, resources

## 3. Board compensation

Board retainer, mandatory stock investment, long-term stock retention, equity grants, advance disclosure of stock transactions

## 4. Executive compensation

Focus on cash compensation, prohibiting retention payments and evergreen contracts, severance programs, shareholder approval of mega awards, limiting stock options, long-term equity retention, retaining compensation consultants, mandatory expensing of options

## 5. Audit committee

Membership, experience standards, meeting requirements, chair rotation, compensation, independence, prohibiting personal use of corporate aircraft and other corporate assets, reviewing related party transactions, reviewing CFO performance, resources, training, overseeing external audit, mandatory auditor rotation, internal audit, reviewing quality of disclosure

## 6. Governance committee

Membership, charter and responsibilities, meeting frequency, shareholder resolution process, overseeing new disclosure committee, remuneration

## 7. Compensation committee

Membership, meeting requirements, chair rotation, remuneration, reviewing related party transactions, reviewing human resources director performance, resources, training, overseeing external compensation advisors

## 8. Risk management committee

Membership, charter and responsibilities, meeting frequency, remuneration

## 9. General corporate issues

Cash flow reporting, dividend policies, transparency policies, strengthening finance department staffing, criteria for shareholders' rights plans

## 10. Legal and ethics programs

Ethics office, pledge, programs, legal department resources, diversity practices

The company, since renamed MCI, is required to implement all the recommendations unless it gets Court approval—which it has not sought—not to implement a specific recommendation. Further, the report recommends that most of the governance standards be placed in the company's Articles of Incorporation. Why is this significant? Because once in the Articles, they can be changed only with prior shareholder consent. This represents an important shift of power from the board to the shareholders, effectively requiring shareholder consent for any changes to governance rules.

While some are hailing the WorldCom recommendations as the definitive blueprint for needed governance reform, others are more cautious, believing certain provisions could be detrimental if implemented blindly. One concern, for example, is the target of paying annual dividends of at least 25% of the company's net income. Critics view such forced payouts as tying management's hands, removing the flexibility the company may need to finance future major investments.

# Commission on Public Trust and Private Enterprise—corporate governance

In January 2003, the Commission on Public Trust and Private Enterprise issued the final two parts of its report, fulfilling its mandate to examine compensation, auditing, and governance issues facing corporate America and issue a series of best practice guidelines. The section on audit and accounting is summarized in *A Brave New World for Audit Committees*. The box summarizes the Commission's principles for corporate governance, which it believes are necessary to help restore public trust. The report also provides specific best practice suggestions underlying each principle.

## Corporate governance principles

### 1. Relationship of the board and management

Each board should establish a structure, based on its particular circumstances, to appropriately balance the powers of the CEO and those of the independent directors, to enable it to carry out its oversight function, and to give independent directors the powers they require in order to perform their oversight roles.

### 2. Fulfilling the board's responsibilities

The core responsibilities of the board include: understanding and approving the company's long-term, central strategies; understanding the issues, forces, and risks that define and drive the company's business; and overseeing management's performance. Key is a vigorous and diligent board, with a substantial majority of independent directors and an appropriate committee structure.

### 3. Director qualifications

Basic qualifications for board membership should be articulated. The mix of director backgrounds and qualifications depends on the nature of the company, its stage of development, its future strategic vision, and its current business needs.

### 4. Role of the nominating/governance committee

The nominating/governance committee—composed entirely of independent directors—should be responsible for nominating qualified candidates to stand for election, monitoring all matters involving corporate governance, and making recommendations to the full board for action in governance matters.

### 5. Board evaluation

The evaluation process should cover the performance of the board as a whole, the performance of each committee, and the performance of each individual director. The board also should adopt a process for evaluating the CEO.

### 6. Ethics oversight

The board should oversee corporate ethics, given that ethical conduct is vital to a company's sustainability and long-term success.

### 7. Hiring special investigative counsel

If an independent investigation is reasonably likely to implicate company executives, the board—not management—should retain special counsel for the investigation.

### 8. Shareowner involvement

Shareowners, particularly long-term shareowners, should act more like owners, by participating in the director nomination process and in proxy statement proposals about business issues and shareowner concerns regarding governance of the company.

### 9. Long-term share ownership

Long-term share ownership best encourages companies to maximize long-term value.

## The tentacles of the governance debate—implications for directors of non-profit organizations

The focus thus far has been on rules for profit-oriented companies—public companies in particular. But attitudes among boards of nonprofit organizations are shifting as well. Increasingly, directors of nonprofits are insisting they understand the

new governance rules and what constitutes leading practice, and are considering which aspects, if any, merit application at their organizations. And many are looking at general ways to improve board effectiveness. Some challenges they're addressing:

- How should the board define “independent”? What are the implications for member associations, where board directors also tend to be association members? How can medical and other nonprofits consider the independence issue, if board members use the goods or services the nonprofit provides—and even may be employed by the organization? How can a board address independence if its members are major contributors or solicit substantial contributions?
- Who should be on the board? If directors have similar backgrounds, are all the skill sets the board needs adequately represented? Does the mix of directors allow the board to add value in all aspects of its oversight?
- What committees does the board need? How applicable are public company committee structures? Should an audit committee be established to oversee financial reporting and the external audit relationship? Should the various committees take on similar roles to their public company cousins?
- Reasonably, how much time can directors be expected to devote? How can the board discharge its responsibilities effectively without a significant time commitment? Will directors resign if they're required to dedicate more time? Will the board be unable to find new directors with sufficient free time to take on the volunteer role?
- Where does power rest? If there are term limits on the board, management provides the only continuity, and since management selects new directors, how can the board ever hope to be an effective fiduciary?
- Is there appropriate transparency? Can those outside the organization easily find information on who the directors are, what their backgrounds are, what the board's responsibilities are, what committees are in place, and how contributions and fees are spent?

And these aren't just philosophical questions. An organization that finds its reputation damaged—for whatever reason—also may find its contribution stream drying up. Recent legal and governmental intervention in nonprofits, taxation authority decisions, media uproar over executive compensation awards, and greater levels of stakeholder activity and pressure are edging nonprofit governance toward the spotlight. Indeed, legal advisors remind directors that, a nonprofit designation notwithstanding, they are dealing with other people's money and owe a duty of care. The days of only casual attention to issues of nonprofit governance appear gone.

## Impact on audit committees

Boards' expanding responsibilities pose significant challenge for directors. Boards already are finding that concerns about time commitments, liability, and reputation are making it increasingly difficult to recruit new members. And although audit committee members look at their own full plates, many also find themselves devoting additional time to other board matters, either through service on other committees or through the longer board meetings resulting from increased attention to discharging board responsibilities.

And boards are under more scrutiny regarding their behavior. The past year has seen the emergence of numerous corporate governance rating schemes, administered by various organizations that now demand additional information from management and directors about the state of governance. Such ratings—and uncertainty as to how they ultimately will be used—are focusing boards' attention anew. And issues like executive compensation are expected to remain at the forefront of shareholders' and observers' concerns.

Directors will want to understand key elements of both the Conference Board and WorldCom reports' recommendations, and be comfortable with how their own practices compare. And directors who serve on nonprofits will want to extend their focus on governance effectiveness to those organizations, understanding the implications and ensuring special challenges are addressed.

## SEC leadership, staff—stability regained

2002 was a challenging year for the SEC—four new Commissioners were appointed, Chairman Harvey Pitt resigned before the end of his term, and Chief Accountant Robert K. Herdman resigned. Following that year of great change and challenge, the SEC focused on regaining stability in 2003. And in many respects, the new stability was essential, as the SEC was obligated to devote extensive effort to drafting and finalizing the new rules mandated by the Sarbanes-Oxley Act.

**The Chairman.** In February 2003, William H. Donaldson became Chairman. Mr. Donaldson understands the capital markets well, having co-founded and served as CEO of the international investment banking and stock research firm Donaldson, Lufkin and Jenrette, and having served as the Chairman and CEO of the New York Stock Exchange, in addition to other executive roles.

**SEC Staff.** Donald T. Nicolaisen became the SEC's Chief Accountant in September 2003. Before joining the SEC, Mr. Nicolaisen was a partner with PricewaterhouseCoopers LLP—and for a six-year stint led its National Accounting and SEC Services practice. He replaced Jackson Day, who became the Acting Chief Accountant in November 2002 following Mr. Herdman's resignation.

Mr. Nicolaisen oversees the SEC's accounting policy initiatives and leads efforts with national and international standard setters on critical accounting and auditing issues. Additionally, he works closely with the Public Company Accounting Oversight Board (PCAOB).

Susan G. Markel was selected Chief Accountant of the Division of Enforcement in June 2003, having joined the Division in 1994. Ms. Markel's role is to advise on investigations involving accounting and auditing matters. She succeeded Charles D. Niemeier, who was appointed to the PCAOB in 2002.

Staff in most other key positions—including the Directors of the Divisions of Corporation Finance (Alan L. Beller) and Enforcement (Stephen M. Cutler), the SEC's General Counsel (Giovanni P. Prezioso), and the Chief Accountant of the Division of Corporation Finance (Carol A. Stacey)—remained unchanged in the past year.

## Improper influence on audits

In May 2003, the SEC issued final rules—driven by Sarbanes-Oxley—dealing with improper influence on the conduct of audits. They supplement previous rules addressing falsifying records and making false or misleading statements, or omitting to make certain statements to auditors. The new rules prohibit officers and directors—or anyone acting under their direction—from “taking any action to coerce, manipulate, mislead, or fraudulently influence” a company's external auditors if that person knew or should have known that the action, if successful, could result in rendering the financial statements materially misleading. And they extend beyond company employees, to prohibit company officers or directors from directing customers, vendors, or creditors to provide false or misleading confirmations or information to auditors, or enter into “side agreements” that ultimately mislead the auditor.

The rules go beyond audits—they also apply to work auditors do in reviewing interim financial statements and issuing consents to the use of audit reports. The terms “officer” and “director” are not set in stone. If, the SEC warns, it appears that members of management not encompassed by existing definitions are engaging in prohibited conduct, it may revise the definitions.

Specifically, the rules view actions to coerce, manipulate, mislead, or fraudulently influence to include trying to have auditors:

- issue or reissue a report on a company's financial statements that is not warranted in the circumstances—because of material departures from generally accepted accounting principles, generally accepted auditing standards, or other professional or regulatory standards
- not perform audit, review, or other procedures required by professional standards
- not withdraw an issued report
- not communicate matters to a company's audit committee

The box shows examples of behaviors the SEC states could constitute improper influence, but the SEC indicates it will consider the facts and circumstances of each case—including the purpose of the conduct—in determining whether the rules have been violated.

## Examples of improper conduct

- Offering or paying bribes or other financial incentives, including future employment or contracts for nonaudit services
- Providing an auditor with inaccurate or misleading legal analysis
- Canceling existing nonaudit or audit engagements—or threatening to—if the auditor objects to the company's accounting
- Trying to remove a partner from the engagement for objecting to the company's accounting
- Blackmailing
- Making physical threats

Audit committees should ensure their expectations of company behavior and auditors' behavior are clear—that no attempts to improperly influence the auditors will be tolerated, and that auditors concerned they are subject to such improper influence will report it to the committee on a timely basis.

## Focus on codes of ethics

As directed by Sarbanes-Oxley, the SEC issued rules in January 2003 requiring companies to disclose whether they have adopted a code of ethics for their CEO, CFO, principal accounting officer or controller, or persons performing similar functions. Companies not adopting such codes must disclose that and explain why.

Companies may have separate codes for different types of officers. The code also may be part of a broader code that addresses additional issues and applies to others, as long as it addresses all elements required in the definition (see box).

## SEC definition of “code of ethics”

Written standards reasonably designed to deter wrongdoing and to promote:

- Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships
- Full, fair, accurate, timely, and understandable disclosure in reports and documents that a company files with, or submits to, the SEC and in the company’s other public communications
- Compliance with applicable governmental laws, rules, and regulations
- Prompt internal reporting of violations to appropriate people identified in the code
- Accountability for adherence to the code

A company with such a code must make it publicly available; it may include the code as an exhibit in its annual report, or post it on its website and disclose the address in its annual report, or offer in the annual report to provide a copy of the code, without charge, to anyone requesting it.

In addition, a company must disclose immediately through venues noted in the rules:

- Any amendment to the code that applies to the CEO, CFO, principal accounting officer or controller, or persons performing similar functions
- Any waiver, including an implicit one, granted to any of those same people, with the person’s name and the date of the waiver

Many companies are choosing to combine the code required under new SEC rules with the codes of conduct required by NYSE and NASDAQ rules, as discussed in *Continuing Focus on Boards*. Although not required under any of the new rules, leading governance practice is for either boards or audit committees to be deeply involved in reviewing and approving codes of conduct, and in monitoring how management personally complies and how it ensures company-wide compliance.

## Lessons from five years of enforcement actions

Sarbanes-Oxley required the SEC to study the previous five years of enforcement actions to identify which areas of financial reporting are most susceptible to fraud, inappropriate manipulation, or earnings management. During the five-year period studied, the SEC filed 515 enforcement actions for financial reporting and disclosure violations, arising out of 227 Division of Enforcement investigations. The number of enforcement actions involving company financial reporting violations or fraud increased from 91 in the first year of the study to 149 in the last. About 10% of the enforcement matters involve accounting or disclosure issues related to financial statements filed during IPOs.

What types of problems did the SEC find?

- **Improper revenue recognition**, including recording fictitious sales, improper timing of revenue recognition, and improper valuation of revenue—126 instances
- **Improper expense recognition**, including improper expense capitalization or deferral, improper use of reserves, and other understatement of expenses—101 instances
- **Improper accounting for business combinations**—23 instances
- **Other accounting and reporting issues**, including inadequate disclosures in MD&A and elsewhere in filings, failure to disclose related party transactions, improper use of off-balance sheet arrangements, and improper use of non-GAAP financial measures—137 instances

Furthermore, the SEC found troubling evidence that most people responsible for the accounting violations were members of senior management. Seventy-five board chairs, 111 CEOs, 111 presidents, 105 CFOs, and 27 VPs of finance faced charges. Additionally, many midlevel managers were implicated in these cases. And the SEC found problems with some audit firms and individual auditors, resulting largely from auditors failing to gain sufficient evidence to support the company's accounting, exercise the appropriate level of skepticism in responding to red flags, and maintain independence.

The SEC study outlines a number of recommendations. It proposes to provide guidance—since issued, as discussed below—to improve overall MD&A disclosure, and to require companies to report restatements in a uniform manner. The SEC also recommends changed or new legislation to:

- Allow companies to provide privileged or protected information to the SEC without waiving any privileges on other information
- Provide SEC staff access to grand jury materials
- Give the SEC authority to serve subpoenas for civil actions, nationwide

## Improving management discussion and analysis

The SEC continues to focus on encouraging companies to improve the quality of their MD&A disclosures. Why? Because MD&A is an important tool in conveying information from management to investors, and it's vital this communication be clear and straightforward. Accordingly, in December 2003, the SEC issued *Interpretive Guidance Regarding Management's Discussion and Analysis of Financial Condition and Results of Operations*, which takes immediate effect.

As background, there are three principal objectives of MD&A:

- Provide a narrative explanation of a company's financial statements that enables investors to see the company through management's eyes
- Enhance overall financial disclosure and provide the context for analyzing financial information
- Provide information about the quality and potential variability of a company's earnings and cash flow, so investors can judge whether past performance is likely to be indicative of future performance

In part, the guidance is driven by concerns the SEC found in its review of Fortune 500 companies' 2002 annual reports. And it addresses a persistent belief that while companies do an adequate job reporting what has happened in quantitative terms, they fall short of discussing why something has happened.

### Overall presentation and focus of MD&A

The guidance prompts companies to:

- Give greatest prominence to the most important information
- Avoid unnecessary duplicative disclosure, which may overwhelm readers and can prevent them from identifying and understanding material matters
- Consider starting their MD&A with an executive-level overview to provide context for the rest of the discussion
- Focus on material information that helps investors understand financial condition, liquidity, capital resources, changes in financial condition, and results of operations
- Identify and discuss key performance indicators—including nonfinancial ones—that management uses to manage the business and that would be material to investors
- Disclose known trends, events, demands, commitments, and uncertainties that are reasonably likely to have a material effect on financial condition or operating performance

- Provide not only basic required MD&A disclosures, but also an analysis explaining management's view of the implications and significance of the information, to satisfy the principal objectives of MD&A discussed above

### Liquidity and capital resources

MD&A should discuss the company's ability to meet upcoming cash requirements over both the short and long terms. Companies should disclose material changes in the underlying drivers of cash flows, rather than merely describing items identified on the statement of cash flows, or reciting changes and other information evident to financial statement readers. And they should consider enhanced disclosure of debt instruments, guarantees, and related covenants.

### Critical accounting estimates

For accounting estimates and assumptions that may be material—due to the subjectivity and judgment needed to account for highly uncertain matters or their susceptibility to change—and that have a material impact on financial condition or operating performance, enhanced discussion and analysis should:

- Supplement—but not duplicate—the description of significant accounting policies in the notes to financial statements
- Provide greater insight into the quality and variability of information regarding financial condition and operating performance

These more robust MD&A discussions accompany a slate of other information that companies will be adding to their upcoming filings and disclosures. Audit committees will want to ensure management has identified the universe of additional disclosures needed and has set out a plan to ensure all the required information is prepared and reviewed internally as part of management's robust disclosure controls and procedures. And audit committees reviewing drafts of the new disclosures will focus on their understandability, transparency, and the extent to which a reader truly will get a sense of why the company's results are what they are.

## Impact on audit committees

Audit committees play a vital role in establishing and enforcing the tone at the top. This role is key to two new SEC rules on ensuring appropriate ethical conduct and clarifying that any attempts to improperly influence auditors will not be tolerated. More audit committees are having explicit discussions with management on these issues, ensuring expectations for ethical behavior are crystal clear. Audit committees also will want to keep in mind the key areas the SEC found as being most susceptible to fraudulent financial reporting—in particular, improper revenue and expense recognition—and understand how they might be present in the financial statements the committee oversees. And, although they should have faith in their management team—otherwise, the board should replace management—audit committees should maintain a questioning and vigilant stance when discussing issues with management, and determine whether management's actions and attitude strengthen or undermine the trust the committee places in the team. And committees will be committing additional time to reviewing financial reports and filings—by taking the time to consider whether they make sense and tell the story of the company's results and challenges.



# Evolving rules for auditors

## Public Company Accounting Oversight Board

Of all the provisions of the Sarbanes-Oxley Act, replacing the profession's self-regulating framework with the PCAOB has the biggest impact on the auditing profession in the United States.

The PCAOB is composed of five full-time members—two certified public accountants and three non-CPAs—and must be chaired by an individual who has not practiced as a CPA for at least five years before appointment. The SEC's initial selection, in October 2002, of a PCAOB chair proved contentious, and the search for a new chair resumed. That search ended with the April 2003 selection of William J. McDonough, President of the Federal Reserve Bank of New York.

The PCAOB has four primary duties:

- **Register public accounting firms.** U.S. accounting firms auditing public companies had to register with the PCAOB by October 22, 2003. At the time of this writing, over 700 firms have applied and had their registration approved, including PricewaterhouseCoopers LLP. Non-U.S. accounting firms must register by April 19, 2004, although the PCAOB has proposed extending that deadline to July 19, 2004. The PCAOB expects to post portions of firms' applications on its website in the future.
- **Establish audit, quality control, and independence standards.** Sarbanes-Oxley gave the PCAOB the authority to adopt AICPA standards or to take on standard setting itself. The PCAOB chose to take responsibility for standard setting itself. As part of the transition, in April 2003, the PCAOB adopted existing AICPA auditing standards as its interim standards. It also has started its own standard setting, most notably by issuing proposed standards for Section 404 attestations, discussed below. Also, the PCAOB is establishing a standing advisory group—approximately 25 members with expertise in accounting, auditing, corporate finance and corporate governance, and investments—to assist the PCAOB in carrying out its standard-setting responsibilities.
- **Inspect public accounting firms.** The eight accounting firms currently auditing more than 100 U.S. public companies will have annual PCAOB inspections. Other firms will be inspected triennially, with the PCAOB expecting to cover roughly 200 firms per year. In 2003, the PCAOB performed "limited procedures" at the Big Four accounting firms—developing an understanding of firm policies, procedures, methodologies, and training programs; visiting certain practice offices; and inspecting the working papers in certain areas of selected audit engagements. The PCAOB commences its full-blown inspections in 2004. It has authority to refer violations of its rules, SEC rules, professional standards, and audit firm quality control policies to the SEC and appropriate state regulatory authorities. Written inspection reports (and audit firms' letters of response) also will be provided to the SEC and appropriate state regulatory authorities—and may be made available to the public if the issues reported are not addressed by the firm to the PCAOB's satisfaction within 12 months after the date of the inspection report.
- **Conduct investigations and disciplinary proceedings.** The PCAOB will investigate and discipline auditors of public companies for professional and ethical violations—shifting this responsibility from the AICPA's former SEC Practice Section. It may impose fines and sanctions against individual auditors and firms, which could include suspending a firm's right to audit public companies.

The PCAOB adopted its first standard—Auditing Standard No. 1—in December 2003. The standard requires auditors' reports on the financial statements of public companies to state that the engagement was conducted in accordance with "the standards of the Public Company Accounting Oversight Board (United States)." This wording replaces the previously required reference to auditing standards generally accepted in the United States of America. And auditors' reports for public companies will have to reflect the revised wording even if the engagement was conducted before the effective date of Auditing Standard No. 1. In addition, auditors must include their city and state—or city and country, in the case of non-U.S. firms—in their reports. The new standard will take effect for auditors' reports issued or reissued 10 days after the SEC approves the standard. The timing of the SEC's approval of the standard is uncertain.

## PCAOB proposed auditing standard for reporting under Section 404

*A Brave New World for Audit Committees* describes the final SEC rules for management's reporting on internal control, as required by Sarbanes-Oxley Section 404. In October 2003, the PCAOB proposed a related standard, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements*. Key elements of the proposed standard include:

- The same auditor must audit both the financial statements and management's assessment of the effectiveness of internal control over financial reporting.
- The auditor must test the effectiveness of internal control over financial reporting in addition to management's assessment process.
- The auditor must evaluate the extent and substance of management's documentation, including whether it provides reasonable support for management's assessment.
- The auditor must evaluate factors (described in *A Brave New World for Audit Committees*) related to the audit committee's effectiveness in overseeing the company's external financial reporting and internal control over financial reporting.
- If a company has one material weakness, that will result in an adverse audit opinion.

The proposed standard outlines expectations for identifying significant accounts and disclosures, relevant financial statement assertions, significant processes, and controls, and then for testing operating effectiveness. The proposed standard directs the scope of auditors' work where there are multiple locations or business units, based on their relative financial significance and risk of material misstatement in the financial statements arising from activities conducted or controls performed in those locations or business units.

The proposed standard also defines two important terms:

- A "significant deficiency" is an internal control deficiency that adversely affects the company's ability to initiate, record, process, or report external financial data reliably in accordance with generally accepted accounting principles. It could be a single deficiency, or a combination of deficiencies, resulting in more than a remote likelihood that a misstatement—of the annual or interim financial statements—that is more than inconsequential in amount will not be prevented or detected.
- A "material weakness" is a significant deficiency that, by itself or in combination with other significant deficiencies, results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

Furthermore, if the audit committee's oversight of external financial reporting and related internal control is ineffective, the auditor should regard that finding as at least a significant deficiency, and a strong indicator that a material weakness exists.

Observers have identified a number of concerns with the proposed standard, including issues relating to companies with multiple locations, using service organizations, acquisitions made close to year end, the extent to which auditors may use management's testing in forming their opinion, and dating the auditors' opinion. As it finalizes the standard, the PCAOB is considering the almost 190 comment letters received.

Evidence to date suggests that significant effort is needed to prepare for Section 404 reporting—far more effort than many companies originally anticipated.

Going forward, the focus on the adequacy of internal control will result in new questions and discussions. If the auditor finds a financial statement error, the resolution doesn't stop with the company booking the correction. Instead, the discussion expands to why the company's internal control systems didn't identify or catch the error—especially if it was material—and the resulting impact on management's and the auditor's annual 404 internal control reports. Future repercussions are potentially even more far-reaching. Will future restatements result in regulators and lawyers revisiting management's previous certifications under Section 302 and previous assertions under Section 404 and suggesting, with hindsight, they were improperly—or even fraudulently—signed? Time will tell.

## Focus on fraud

Even though another year has elapsed since Enron and WorldCom hit the public consciousness, the focus on fraud isn't dimming. Indeed, with media coverage of high-profile European companies like Parmalat, the scrutiny likely won't subside anytime soon. *SEC Focus* describes the 2003 SEC study on five years of enforcement actions—and its finding that improper revenue and expense recognition top the list of fraudulent financial reporting practices.

In October 2002, the Auditing Standards Board issued SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*.<sup>9</sup> SAS 99 is effective for calendar 2003 audits. Audit committees and companies will see some important shifts in audit approach under the new standard:

- Increased emphasis on auditors' skepticism, with a mind-set that recognizes the possibility of a material misstatement due to fraud, regardless of past experience with the company or of the auditor's belief about management's honesty and integrity
- New focus on management's antifraud programs and controls, and consideration of the risk of management override of controls
- The presumption that revenue recognition is a fraud risk, and application of specific auditing procedures on journal entries, other adjustments, accounting estimates, and significant unusual transactions
- An element of unpredictability in the auditing procedures selected—testing accounts not normally tested, adjusting the timing of testing from what's expected, and performing procedures at different locations or on an unannounced basis
- No assumption that a misstatement or error is an isolated incident, instead considering whether it's indicative of fraud

A key element of SAS 99 is the requirement for auditors to inquire directly of the audit committee or its chair regarding the committee's views about the risks of fraud, whether it knows of any fraud or suspected fraud, and how the committee oversees the company's assessment of fraud risks and its programs and controls to mitigate the risks. Additionally, both shareholders and regulators are looking to audit committees to do their part to ensure that company management is addressing the risk of fraud appropriately and, to the extent possible, that management is not itself perpetrating fraud. The box provides some sound practices for committees in this area.

### Audit committees' oversight of fraud prevention—key factors

- Ensuring management sets the right tone at the top and avoids a corporate culture of playing fast and loose with the rules.
- Understanding how susceptible the company is to fraudulent financial reporting and how easy it would be for management to override internal controls. Also, understanding the key estimates and judgments that could be susceptible to manipulation or management bias.
- Understanding the types of fraud most prevalent in the company's industry and determining the committee's level of comfort with specific steps management takes to address fraud risk.
- Discussing compensation plans and targets with the compensation committee, thus ensuring the plans reward proper behavior and don't encourage fraud. Also, considering other pressures—like meeting earnings guidance provided to analysts or meeting debt covenants—that could induce management to commit fraud.
- Taking an active role in overseeing the complaint processes and ensuring allegations are appropriately addressed, as described in *A Brave New World for Audit Committees*.
- Comparing the committee's understanding of how the business performed and its operating results against reported results. Are they comparable? Is the financial reporting understandable? Transparent?

<sup>9</sup> See full description in *Current Developments for Audit Committees 2003*, available at [www.pwc.com/uscorporategovernance](http://www.pwc.com/uscorporategovernance).

For further discussion on fraud, see the PricewaterhouseCoopers report, *Key Elements of Antifraud Programs and Controls: A White Paper*.<sup>10</sup>

## Auditor independence rules

In January 2003, as directed by Sarbanes-Oxley, the SEC issued final new rules on auditor independence. The rules, which took effect May 6, 2003:

- Define nonaudit services that would impair independence if provided to an audit client
- Prohibit certain audit partners from providing audit services to a client for more than five or seven consecutive years, depending on the partner's role
- Indicate that an audit partner's independence is impaired if he or she receives compensation based on selling engagements to an audit client for services other than audit, review, and attest services
- Prohibit an accounting firm from auditing an issuer's financial statements if certain members of company management had been members of the audit engagement team within the one-year period preceding the start of the audit
- Require different proxy statement disclosures of fees billed by the auditor for audit and nonaudit services and additional disclosures about the audit committee's preapproval process

Other elements of these new rules—requiring audit committee preapproval of audit and nonaudit services and requiring the auditor to communicate certain matters, including about critical accounting policies, to the audit committee—are discussed in *A Brave New World for Audit Committees*.

### Nonaudit services

The SEC applies three basic principles when considering questions of auditors' independence—that an auditor cannot:

- function in the role of management
- audit his or her own work
- serve in an advocacy role for his or her client

The SEC is applying these principles in defining prohibited services, outlined in the box and described in greater detail in the rules themselves.

<sup>10</sup> Available at our website, [www.pwc.com/uscorporategovernance](http://www.pwc.com/uscorporategovernance).

## Prohibited nonaudit services

- Bookkeeping or other services related to the accounting records or financial statements of the audit client
- Financial information systems design and implementation
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports
- Actuarial services
- Internal audit outsourcing services
- Management functions or human resource services
- Broker-dealer, investment advisor, or investment banking services
- Legal and expert services unrelated to the audit

The rules reiterate the SEC's long-standing position that providing tax services doesn't impair independence. Thus, auditors can continue to provide tax services—tax compliance, tax planning, and tax advice—to audit clients, as long as the audit committee preapproves them. The change, though, is that now the fees for such services have to be disclosed separately.

### Other auditor independence provisions

**Partner rotation.** The new rules mandate rotation of the lead audit partner and concurring review partner every five years—down from seven years for lead audit partners previously—with a five-year “time out” before the partner can return to the engagement. The transition provisions allow lead audit partners in their fifth, sixth, or seventh year of service to complete a fiscal year 2003 audit and concurring review partners who have completed their sixth or seventh (or greater) year of service to complete audits for fiscal years 2003 and 2004 before rotation is required. Other “audit partners” will rotate every seven years starting with years beginning after May 6, 2003, with a two-year time out.

“Audit partners” include partners who:

- Are responsible for decision making on significant auditing, accounting, and reporting matters that affect the financial statements
- Maintain regular contact with management and the audit committee
- Serve the client at the parent or SEC reporting entity level
- Are lead partners on subsidiaries whose assets or revenues constitute 20% or more of the consolidated assets or revenues

The audit partner definition does not include “specialty” partners, who consult with others on the audit engagement team regarding technical or industry-specific issues—like tax or valuations—and who are not required to rotate.

Although these rules are directed at auditors, the new NYSE governance rules instruct audit committees to ensure the regular rotation of the lead audit partner, as part of the committee's assessment of auditors' independence.

**Partner compensation.** Under the new rules, the lead, concurring, and other audit partners would not be independent if they earn or receive compensation based on selling nonaudit engagements to an audit client.

**Cooling-off period.** The rules also indicate that independence would be impaired if the lead or concurring partner, or any other member of the audit engagement team who provides more than ten hours of audit, review, or attest services during the annual audit period, accepts a position with the company in a financial reporting oversight role within a one-year period preceding the start of the current audit.

The new NYSE governance rules dovetail nicely with these rules, as they require audit committees' charters to include responsibility for setting clear hiring policies for employees or former employees of the external audit firm.

### Additional disclosures

The new SEC rules require companies to disclose fees paid to their auditors for the two most recent years in four categories of services:

- **Audit:** All services performed to comply with generally accepted auditing standards (GAAS), including services normally provided in connection with statutory and regulatory filings or engagements, such as comfort letters, statutory audits, attest services, consents, and assistance with and review of documents filed with the SEC. Also may include an appropriate allocation of fees for tax services and accounting consultations to the extent they are necessary to comply with GAAS.
- **Audit-related:** Includes assurance and related services, such as employee benefit plan audits, due diligence related to mergers and acquisitions, accounting consultations and audits in connection with acquisitions, internal control reviews, attest services not required by statute or regulation, and consultations concerning financial accounting and reporting standards.
- **Tax:** All services performed by professional staff in the auditor's tax division except those related to the audit, as noted above. Includes tax compliance—preparing original and amended tax returns, refund claims, and tax-payment planning—tax planning, and tax advice, such as assistance with tax audits and appeals, tax advice related to mergers and acquisitions and to employee benefit plans, and requests for rulings or technical advice from taxing authorities.
- **All other:** All other services.

For the last three categories, companies must describe, in qualitative terms, the types of services provided, again for the previous two years. It's also recommended that companies describe the services under the audit category.

Companies must include these fee disclosures in their proxy statements. Additionally, companies must disclose the audit committee's preapproval policies and procedures, and if the *de minimis* exception was used, the percentage of the total fees paid to the independent accountant under that exception, by category. Companies not filing proxy statements with the SEC would include these disclosures in their annual filings with the SEC.

## Consolidation of the accounting profession

As mandated by Sarbanes-Oxley, in July 2003 the United States General Accounting Office (GAO) released its study on consolidation and competition of public accounting firms. The GAO report notes the "Big Four" audit over 78% of all U.S. public companies, 97% of all public companies with sales over \$250 million, and 99% of all public company sales. Among the report's findings:

- No evidence of impaired competition for audit services to date, but possible implications for future competition and public company choice
- No evidence to suggest consolidation among firms had a direct impact on capital formation or the securities markets
- Smaller accounting firms face significant barriers to entry into the audit market for large and complex national and multi-national public companies—as they generally lack the staff, technical expertise, and global reach to audit such companies

The focus on large national and multinational companies is important. Such companies need audit firms with substantial staff resources, industry-specific and technical expertise, extensive geographic coverage, and international reputation. And consolidation has limited the choices such companies have—a limitation exacerbated in some cases by conflicts of interest, independence rules, and industry specialization. Thus, the report notes that if large companies voluntarily switch auditors, or become required to do so if mandatory firm rotation is adopted, they might be hard pressed to find an acceptable alternative. Indeed, 88% of public companies that responded to the GAO survey indicated they would not consider using a non-Big Four firm for audit and attest services.

The report ends with a few comments about the unprecedented change and evolution in the audit market. It recognizes the tremendous challenges audit firms face in adapting to the new world. It recommends future studies revisit whether the current level of concentration—including industry share concentration—has an impact on audit price, audit quality, and competition. Importantly, it also warns against further consolidation of the Big Four, whether voluntary or involuntary. It cautions regulators and enforcement agencies to balance the firms' and the individuals' responsibilities when problems are uncovered and to target sanctions against partners and employees rather than against the entire firm. On the other hand, it also cautions firms not to fall into the trap of believing they are "too few to fail," even in this day and age.

So what does the consolidation of the public accounting profession mean for audit committees? The number of alternative suppliers of audit services may prompt some audit committees to review the nature and extent of the company's professional services and other relationships, if any, with accounting firms other than its external auditors—to understand any implications that pertain to those firms' eligibility to possibly serve as external auditors in the future.

## Mandatory auditor rotation

In its hearings that ultimately led to the adoption of Sarbanes-Oxley, Congress considered whether mandatory audit firm rotation—setting a limit on the number of years a public accounting firm may audit a particular company's financial statements—would enhance auditor independence and audit quality, but decided the issue needed further study. Accordingly, the GAO was directed to study mandatory audit firm rotation and, in November 2003, released its report.

At the heart of the issue is the debate about whether a public accounting firm's independence is adversely affected by its long-term relationship with the client and the desire to retain the client. Among the concerns are whether the intended benefits of mandatory audit firm rotation would outweigh the costs; and the loss of company-specific knowledge gained through years of experience auditing a client. Additionally, reforms now in place, driven by Sarbanes-Oxley, may accomplish the intended benefits of mandatory audit firm rotation.

The report's specific findings:

- Based on surveys conducted as part of the study, almost all of the Fortune 1000 publicly traded companies, their audit committee chairs, and the largest public accounting firms believe that the costs of mandatory audit firm rotation are likely to exceed the benefits.
- Most of the survey respondents believe the current requirements for audit partner rotation, auditor independence, and other reforms—once fully implemented—will be sufficient to achieve the intended benefits of mandatory audit firm rotation.
- Interviews with other stakeholders, including institutional investors, stock market regulators, bankers, accountants, and consumer advocacy groups, found their views to be consistent with the overall views of survey respondents.

The report concludes with the GAO's belief that mandatory audit firm rotation may not be the most efficient way to strengthen auditor independence and improve audit quality—while potential benefits are hard to predict and quantify, there is a fair amount of certainty there will be additional costs. The GAO believes the SEC and PCAOB should monitor and evaluate the effectiveness of existing requirements for enhancing auditor independence and audit quality over the next several years. And the GAO believes audit committees—with their increased responsibilities under Sarbanes-Oxley—can play an important role in ensuring auditor independence. To fulfill this role, audit committees must themselves be independent and have adequate resources. Finally, for any system to function effectively, there must be incentives for the various parties to do the right thing, adequate transparency over what is being done, and appropriate accountability if the right things are not done.

## Impact on audit committees

Audit committees should be aware of the new scrutiny being placed on audit firms, and that the PCAOB is contacting some audit committee chairs of companies whose audits it is inspecting, to discuss the effectiveness of the external auditors' communications. This focus on communications should prompt committees to carefully consider the quality of

auditor communications and to discuss any concerns with their auditors. Audit committees of private companies considering initial public offerings will want to ensure their auditors are registered with the PCAOB so that, when the company goes public, regulators will accept the auditors' report. And on the topic of auditors' reports, committees can expect to see new wording, referring to PCAOB standards instead of GAAS.

Audit committees need to appreciate the significant effort entailed in upcoming 404 reporting and will want to understand the approach auditors will be taking in upcoming 404 attestation. With 404 reporting and the continuing focus on fraud, audit committees will be paying particular attention to any internal control deficiencies, misstatements, and fraud risks that come to light during the 2003 reporting cycle, with an eye to any implications for current disclosure requirements and, ultimately, management's and the auditors' reporting in connection with 404 provisions. And committees will want to take a fresh look at their oversight responsibilities and practices regarding the company's procedures designed to prevent and detect fraud, incorporating any new information they're receiving from complaint processes, and ensuring they are communicating with the auditors on such issues.

As part of assessing auditor independence, audit committees will need to fully understand the new rules that apply—those enumerated by the SEC as well as the stock exchanges. Committees also will be reviewing new and more robust disclosures of fees paid to auditors and considering other proxy statement disclosures about their preapproval policies and practices. And audit committees of companies that are considering future public offerings will want to carefully consider their relationships with their auditors going forward, to ensure any nonaudit services provided by the auditors, and any company hiring of audit firms' employees, don't taint the auditors' independence—making them ineligible to sign the three years of audit reports needed.

# The international scene

## Rebuilding public confidence in financial reporting—an international perspective

The International Federation of Accountants' (IFAC) Task Force on Rebuilding Public Confidence in Financial Reporting issued its report in 2003. The Task Force, chaired by John Crow, former Governor of the Bank of Canada, was asked to identify and analyze reasons for the loss of credibility in financial reporting, consider alternative actions that might restore credibility, and recommend best practices in financial and business reporting, corporate governance, and auditor performance. Its initial discussions confirmed that low credibility of financial reporting is a serious and widespread issue.

The report's main recommendations:

- Effective corporate ethics codes need to be in place and actively monitored. They should be widely distributed within the company and to shareholders, and related training and support provided to help individuals facing tough ethical issues. Boards need to develop procedures to monitor these codes.
- Corporate management must place greater emphasis on the effectiveness of financial management and controls. Formal reports to shareholders should explain management's responsibility for these areas and include regular assessment by the audit committee of the appropriateness of resources devoted to internal control. The CFO should be knowledgeable about reporting and controls. And internal audit should report directly to the CEO, with unfettered access to the audit committee.
- Incentives to misstate financial information need to be reduced. Companies should avoid providing precise profit forecasts. Accounting standards should require expensing of share options. Independent directors should determine senior management's compensation.
- Boards of directors need to improve their oversight of management, regularly evaluating CEO performance and assessing factors such as ethical leadership. Boards also should evaluate their own and their members' performance regularly.
- Threats to auditor independence need to receive greater attention in corporate governance processes and by auditors themselves. Auditors should report to audit committees, not to management. Other ways to enhance independence: adopting national independence codes that are based on the IFAC Code of Ethics, rotating key audit personnel, reassessing audit firms' compensation practices, and requiring audit committee preapproval both of nonaudit services and of company hiring of key audit team members, with related disclosures for both areas.
- Audit effectiveness needs to be raised primarily through greater attention to audit quality control processes, including audit firm tone at the top, hiring, training, client acceptance and retention, internal consultations, concurring partner reviews, and disclosures of quality control processes and financial information.
- Codes of conduct need to be put in place for other participants in the financial reporting process, and their compliance monitored. Financial analysts, lawyers, and investment banks should adopt these codes, which should focus particularly on the advice lawyers and investment bankers provide. The codes should be disclosed publicly and monitored both within the respective organizations and externally. Lawyers should explain their advocacy positions and summarize significant issues so boards can better evaluate the advice. And credit-rating agencies should disclose their criteria, evaluation processes, and quality control mechanisms.
- Audit standards and regulation need to be strengthened. International Standards on Auditing issued by the International Auditing and Assurance Standards Board should become the worldwide standards, with convergence between national and international standards as soon as possible. Countries should adopt best practices for external quality assurance reviews of audit firms.

- Accounting and reporting practices need to be strengthened, ideally by adopting International Financial Reporting Standards. Greater focus should be given to convergence, and standard setters and regulators should consider how financial statements could provide additional information, more understandably and on a more timely basis.
- The standard of regulation of issuers needs to be raised, through early implementation of national regulations consistent with the Principles of Securities Regulation issued by the International Organization of Securities Commissions. Also, regulators should conduct post-issue reviews of financial statements for compliance with accounting standards.

Some recommendations have already been adopted in the United States, either through SEC rules or through listing standards. International adoption is inconsistent, and no one country is embracing all elements of the recommendations.

The Task Force believes action is required at both national and international levels, and at all points along the information supply chain that delivers financial reporting to the market. And, both institutional and individual integrity is vital in restoring public trust. The Task Force therefore urges all those with an interest in financial reporting to build on the positive national and international developments so that credible financial reporting can regain its central position in the functioning of the market economy.

## International accounting convergence—gaining momentum

### Global GAAP—the future of corporate reporting<sup>11</sup>

The global nature of capital markets is a key factor behind the unrelenting demand for high-quality global accounting standards. In the United States, the Financial Accounting Standards Board (FASB) is committed to working with the International Accounting Standards Board (IASB) toward converging U.S. accounting standards and International Financial Reporting Standards (IFRS). The ultimate goal is to establish IFRS as a global set of generally accepted accounting standards—Global GAAP—which eventually can be accepted in some form by U.S. regulators without reconciliation to U.S. GAAP. How? The process starts with finding the highest common denominator among U.S. GAAP, other existing national standards, and IFRS—or creating it. Ideally, Global GAAP will:

- Base itself on principles rather than on detailed rules or so-called “bright lines”
- Focus on the substance of transactions
- Provide financial information that is transparent, understandable, and written in plain language
- Include global mechanisms for interpreting and enforcing standards so they will be applied consistently
- Reduce costs for cross-border issuers
- Increase comparability of financial statements for investors

Ultimately, what the global markets need is an integrated framework in which all relevant financial and nonfinancial information is presented in a way that not only is understandable, but also is decision-useful and permits meaningful comparisons from year to year within and between entities.

From the European Union (EU) to Canada and Australia, regulatory agencies are rapidly endorsing or requiring the adoption of IFRS. Based on recent estimates, over 7,000 European companies will be affected by the mandatory conversion to IFRS in 2005. The approach to convergence varies country by country, with some:

- Replacing national GAAP with IFRS, and supplementing IFRS only if they do not address certain issues
- Incorporating IFRS into national GAAP on a standard-by-standard basis
- Eliminating differences between IFRS and national GAAP wherever possible

<sup>11</sup> See PricewaterhouseCoopers’ white paper, *Global GAAP—The Future of Corporate Reporting*, available at [www.cfodirect.com](http://www.cfodirect.com).

The United States, meanwhile, is taking a hybrid approach—creating joint standards that reflect the best standards from the IASB, the FASB, and other standard setters around the world.

The SEC acknowledges foreign issuers' wish not to have to reconcile their primary financial statements to U.S. GAAP. As part of its support for convergence, the SEC is working closely with its counterparts in other countries toward consistency among critical accounting standards.

### Global GAAP in the United States

The move toward convergence will affect—either directly or indirectly—most companies in the United States. The direct impact comes from changes to U.S. GAAP flowing from the FASB's work on converging specific areas with IFRS.

Indirect impacts also may be significant. Certain U.S. companies will be particularly affected by IFRS conversion efforts in Europe:

- U.S. subsidiaries of EU-listed companies may be required to report IFRS-compliant financial information to their parent company
- Investors increasingly will demand that U.S.-based multinationals provide financial data prepared in accordance with IFRS
- U.S. decision makers pursuing global investments and strategic partnerships will need to be familiar with IFRS to understand possible targets' and partners' financial statements
- EU member states may require European subsidiaries of U.S. multinationals to prepare statutory financial statements in accordance with IFRS
- A proposed European prospectus directive would require U.S. companies listing securities on foreign exchanges to file financial statements in accordance with IFRS

Notwithstanding the compelling business reasons pushing toward international convergence, there are a number of barriers, including a scarcity of trained resources and sparse understanding—or even awareness—of IFRS among many parties.

### IASB activities

In June 2003, the IASB issued its first standard, IFRS 1, *First Time Adoption of International Financial Reporting Standards*. Companies must apply IFRS 1 if their first IFRS financial statements are for a period beginning on or after January 1, 2004. Its objective is to ensure those first IFRS financial statements contain high-quality information that:

- Is transparent for users and comparable over all periods presented
- Provides a suitable starting point under IFRS
- Provides benefits to users that exceed the costs to generate it

In addition to IFRS 1, the IASB finalized its comprehensive improvements project—which amends 12 previously issued standards and withdraws one. It also issued amendments to IAS 32 and IAS 39 related to financial instruments. And it has issued a number of exposure drafts, many involving complex accounting topics ranging from business combinations, to equity-based compensation, to insurance industry accounting. By the end of March 2004, the IASB expects to have a “stable platform” of financial reporting standards in place for the 2005 IFRS deadline. Companies are encouraged to monitor the IASB's work and comment on exposure drafts relating to their interests. Information on IASB activities and rule making is at [www.iasb.org.uk](http://www.iasb.org.uk).

## The growing importance of international auditing standards

Accompanying the move toward converging accounting standards is the global convergence of auditing standards. High-quality, harmonized auditing standards will strengthen public confidence in the global auditing profession and give investors confidence to trust audit reports from anywhere around the world.

The International Auditing and Assurance Standards Board (IAASB)—functioning as an independent standard-setting body under the auspices of the International Federation of Accountants—is charged with establishing high-quality auditing, assurance, quality control, and related services standards, thereby improving the quality and uniformity of practice throughout the world. It publishes guidance for financial statement audits in International Standards on Auditing, or ISAs, and International Audit Practice Statements, or IAPs.

## Europe adopts ISAs in 2005

The European Commission (EC), believing that common auditing standards are key to a uniformly high level of audit quality throughout the EU, is working toward the goal of adopting ISAs for all EU statutory audits starting in 2005.

Before this, however, some changes are needed. In its strategy issued in 2003, the EC acknowledged the important improvements made during 2002 to the IAASB's process—including increased transparency and adding IAASB members to represent the public interest. But it remained concerned that there is inadequate public oversight of the IAASB's standard setting, which is vital to its legitimacy as a global standard-setting body. Accordingly, following a year of study and discussions with global regulators and other key stakeholders, in November 2003 IFAC adopted governance changes, including the creation of the Public Interest Oversight Board, an independent body charged with overseeing IFAC's public interest activities. The new oversight process will be put in place in 2004—in time for Europe's adoption of ISAs in 2005.

## IAASB's program

Over the past year, the IAASB has accelerated its work program in anticipation of the 2005 European adoption of ISAs. The aim is to complete revisions to core standards before June 2004, to allow sufficient time for their implementation before 2005. These core standards include:

- **Risk assessment standards.** The standards resulting from the IAASB's joint project with the U.S. Auditing Standards Board—ISA 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, ISA 330, *The Auditor's Procedures in Response to Assessed Risks*, and ISA 500 (revised), *Audit Evidence*—were approved and issued in October 2003. The ISAs establish standards and provide guidance for obtaining an understanding of a company and its environment, including its internal control; for assessing the risks of material misstatement in a financial statement audit; and for designing auditing procedures responsive to assessed risks.
- **Fraud.** The IAASB's exposure draft of ISA 240, *The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements*, once finalized, will bring the international standard in line with the U.S. auditing standard on fraud, discussed in *Evolving Rules for Auditors*.
- **Planning.** The IAASB exposure draft of ISA 300, *Planning the Audit*, aligns standards on audit planning with the new risk assessment standards.
- **Auditor's report.** The IAASB's proposed revisions to ISA 700, *The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements*, recommend new wording for the auditor's report, strengthen guidance on matters the auditor considers when forming an audit opinion, and address other practice issues such as the date of the auditor's report and supplementary information.
- **Group audits.** The IAASB proposed revisions to ISA 600, *The Work of Related Auditors and Other Auditors in the Audit of Group Financial Statements*, and a new IAPS, *The Audit of Group Financial Statements*, to address issues arising when related or other auditors are involved in auditing components of a group and to provide guidance to help auditors apply concepts such as materiality and risk assessments in a group audit engagement.
- **Review of interim financial information.** This IAASB exposure draft covers reviews of interim financial information performed by the company's auditor, filling a gap in current international standards.

In addition to the new and emerging core auditing standards, during 2003 the IAASB issued exposure drafts of new standards and guidance for ensuring audit quality, including for firms' quality control over their audit, assurance, and related services practice, as well as for specific quality control procedures that should be implemented on audit engagements.

The IAASB also is working on revisions to its ISAs on materiality, accounting estimates, and documentation, although these projects likely won't be completed by the 2005 deadline, but would become effective in 2006.

The new Public Company Accounting Oversight Board (PCAOB) now sets auditing standards for U.S. public companies. Thus, true international convergence will be possible only if the PCAOB recognizes and accepts international auditing standards for U.S. public company audits. Time will tell what priority the PCAOB assigns to global convergence of auditing standards.

PricewaterhouseCoopers continues to support efforts to converge both financial reporting standards and auditing and assurance standards across the world, providing resources and playing active roles in IFAC, IAASB, and IASC initiatives.

## Emerging rules for foreign issuers

Foreign issuers have long been encouraged by the SEC and U.S. stock exchanges to register their securities in the United States. Reflecting the fact they are subject to different reporting regimes, foreign issuers typically were not subject to the same requirements as U.S. companies. That's changing. The majority of the new SEC rules emerging from Sarbanes-Oxley make no distinction between foreign and domestic issuers. So unless the rules contain specific accommodations, foreign issuers registered in the United States must comply with the same requirements as domestic issuers. The rules finalized in 2002—such as the requirement for foreign issuers to provide Section 302 certifications—are discussed in last year's publication.<sup>12</sup> For rules finalized during 2003, see discussion of the full rules as they apply to domestic issuers elsewhere in this publication.

### Using non-U.S. GAAP financial measures

The final rules on conditions for using non-GAAP financial measures, described in *Developments Affecting Financial Reporting*, generally apply to foreign issuers. However, foreign issuers can enjoy a limited exemption from the public disclosure requirements for non-GAAP financial information if the information is in a document that is not filed with the SEC and if:

- The foreign issuer's securities are listed or quoted outside the United States
- The non-GAAP financial measure is not derived from a U.S. GAAP measure
- The disclosure also is made outside the United States and is not targeted to U.S. investors

Foreign issuers also receive an accommodation regarding disclosure requirements. They are permitted to disclose information in their financial statements that otherwise would be prohibited—if they are required or expressly permitted to do so under local-country GAAP, and if the measure is included in the annual report or financial statements used in their home jurisdiction. The SEC is still evaluating certain aspects of how this rule should be applied in practice, and companies may be obligated to change the format of their income statement and per share information in SEC filings.

### Enhanced financial disclosures of off-balance sheet transactions

The final enhanced SEC disclosure rules regarding off-balance sheet arrangements, contractual obligations, and contingent liabilities and commitments apply to foreign issuers that file annual reports on Forms 20-F and 40-F. The rules do not apply to information included on Form 6-K, however. Consistent with existing rules regarding foreign issuers' MD&A disclosures, the enhanced financial disclosures should focus on GAAP used in the primary financial statements, while taking into consideration any reconciliation to U.S. GAAP that would be necessary for an understanding of the financial statements.

### Audit committee financial experts

Similar to domestic issuers, foreign issuers must disclose in their 20-F or 40-F annual reports whether or not the audit committee has at least one financial expert and, if so, that person's name and whether he or she is independent. If there is no financial expert, companies must explain why. The final rules clarify that under the definition, the audit committee financial expert must understand GAAP used in preparing the company's primary financial statements, and is not required to understand U.S. GAAP. Foreign issuers must comply with this disclosure requirement starting July 31, 2005.

### Code of ethics disclosure

New SEC rules require foreign companies to disclose in their 20-F or 40-F annual reports whether or not they have a code of ethics and, if not, why. But unlike domestic companies, foreign issuers don't have to immediately disclose any changes to or waivers from the code granted to certain corporate officers; instead, those disclosures are included in the annual

<sup>12</sup> See *Current Developments for Audit Committees 2003*, available at [www.pwc.com/uscorporategovernance](http://www.pwc.com/uscorporategovernance).

report to the SEC. Nonetheless, the SEC encourages foreign issuers to use Form 6-K or their website to disclose such changes or waivers on a timely basis.

## SEC review

Sarbanes-Oxley driven rules require the SEC to review the financial statements and disclosures of all listed companies at least once every three years. Canadian companies listing securities in the United States and filing under the Multijurisdictional Disclosure System haven't been subject to SEC review of their financial statements in the past. The SEC isn't aware of any exception in the new rules that would exclude any foreign issuers from this SEC review going forward.

## Additional Form 8-K disclosures

In June 2002, the SEC proposed a rule calling for a significantly expanded list of events requiring reporting in Form 8-K. Although foreign issuers don't file an 8-K, they are required to furnish a Form 6-K covering certain events disclosed in the company's home country, filed with stock exchanges, or distributed to security holders. Under consideration is whether the suggested list of matters for reporting in Form 6-K should be conformed to the proposed expanded list for Form 8-K.

## Audit committee requirements

The NYSE and NASDAQ must prohibit the listing of any security of any company that does not have an audit committee satisfying certain criteria set out in SEC rules. As discussed in greater detail in *A Brave New World for Audit Committees*, the audit committee must:

- Consist entirely of independent members, per the SEC independence definition
- Have responsibility to select and oversee the external auditors
- Establish procedures to receive, retain, and treat complaints regarding accounting, internal control, or auditing matters
- Have the authority to engage advisors
- Receive funding for the external auditors and any outside advisors engaged

But given foreign corporate governance arrangements differ significantly from practices in the United States, foreign issuers get certain accommodations:

- Nonexecutive employees may serve on audit committees if elected pursuant to the foreign issuer's governing law or documents
- For two-tiered board systems, the supervisory or nonmanagement board may serve as the audit committee or form a subcommittee to fulfill the audit committee function
- In certain circumstances, an audit committee member may be a controlling shareholder or a foreign government representative
- In certain circumstances, a board of auditors may serve as the audit committee

## Auditor independence

Sarbanes-Oxley changes requirements for auditors' independence, with new rules equally applicable for foreign issuers. Legal services are precluded; however, the SEC understands that in some jurisdictions, tax services must be provided by licensed law practitioners, and makes it clear that foreign accounting firms can provide tax services. The rules are not intended to prohibit foreign accounting firms from providing services that a U.S. accounting firm may provide.

The lead and concurring review audit partner rotation requirements are the same as for domestic issuers; however, the clock for non-U.S. partners' service period starts with fiscal years beginning after May 6, 2003. For partners other than lead and concurring partners, the requirement to rotate every seven years with a two-year, time-out period is the same as for comparable U.S. partners.

Foreign issuers' audit committees likewise must preapprove all audit and nonaudit services provided by the auditors. And the same rules for new communications between auditors and the audit committee apply. Those communications must be made in writing prior to filing with the SEC. If foreign registrants issue annual reports in their local markets several weeks

or months before their U.S. GAAP reconciliation and Form 20-F are complete, this new rule will drive new communications, possibly resulting in significant changes to the timing of audit committee meetings.

## PCAOB regulation

All accounting firms that audit companies listed in the United States, including non-U.S. firms, must register with the Public Company Accounting Oversight Board. At the time of this writing, non-U.S. accounting firms must register by April 19, 2004, although the PCAOB proposes to extend that deadline to July 19, 2004. The PCAOB grants certain accommodations to non-U.S. accounting firms regarding potential conflicts in law surrounding the oversight system, and the registration information that must be provided. Companies, including foreign issuers, must pay a portion of the accounting support fee based on their market capitalization; however, the method of determining how this cost will be applied to foreign issuers has not been determined at the time of this writing. The PCAOB has a proposed rule covering how it will work with its foreign counterparts to oversee the registration and inspection of foreign accounting firms.

## Management discussion and analysis

*SEC Focus* discusses the SEC's interpretive guidance for improving MD&A. This guidance is equally applicable to foreign issuers. Foreign issuers are directed to focus on their primary financial statements in their discussion and analysis. However, they also are required to discuss any differences between foreign and U.S. GAAP that they believe are necessary for an understanding of the financial statements as a whole.

## Delisting and deregistering

The significant new regulatory and disclosure requirements placed on companies listing securities in the United States and registering with the SEC are causing some foreign issuers to consider delisting and deregistering their securities. Delisting from the NYSE or NASDAQ is a fairly simple process; however, delisting does not eliminate the requirement to file with the SEC.

The process for deregistering is more stringent. To deregister, a foreign issuer must certify to the SEC that the issuer's registered securities are held by fewer than 300 people resident in the United States, or fewer than 500 people resident in the United States, if the issuer's total assets did not exceed \$10 million on the last day of each of the company's most recent three fiscal years. Once this certification—called a Form 15—has been filed, the issuer no longer has any duty to file reports under Section 13(a) of the Act. Ninety days after filing, registration of the securities is terminated. Calculating the number of U.S. security holders can be complex—issuers must “look through” the recorded ownership of brokers, dealers, banks, or nominees holding securities for the accounts of their customers to determine the residency of those customers.

Both delisting and deregistering of securities are legal matters and may require significant consultation with U.S. securities counsel.

## Stock exchange requirements

The new NYSE governance rules generally don't apply to foreign issuers, except for the SEC-driven rules for audit committees, discussed above. The NYSE does, however, require listed foreign issuers to disclose any significant ways in which their corporate governance practices differ from requirements for domestic companies under its listing standards. The NYSE envisions this disclosure will be a brief and general summary of the significant differences—not overly detailed, but enough to let U.S. shareholders understand how the foreign issuer's governance differs from that of a U.S. listed company. The disclosure can be provided on the company's website, as long as it's accessible from the United States and in English, or in the annual report distributed to U.S. shareholders, in English. If the company has only website disclosure, the annual report must give the website address for the information.

NASDAQ generally takes a different approach to applying its audit committee and governance rules to foreign issuers. Its previous governance rules varied based on when a company's securities were listed—foreign issuers listing securities starting December 14, 1999 were required to either comply with the audit committee rules established in 1999 or request a special exemption, whereas companies listing previously were strongly encouraged but not required to comply with those requirements.

Under its new rules, NASDAQ clarifies that it won't require foreign issuers to act in any way contrary to laws, rules, regulations, or generally accepted business practices in their home countries, and so will provide exemptions where warranted. But it points out that its ability to provide such exemptions is restricted to NASDAQ-specific rules, and it can't exempt companies from applicable SEC rules for audit committees. Any company receiving exemptions from NASDAQ rules will have to disclose in its annual reports filed with the SEC each requirement it's exempted from and the home-country practice, if any, followed instead. And foreign issuers also will have to disclose this information in their registration statements

when making their initial public offering or first U.S. listing on NASDAQ. Foreign issuers will have to comply by July 31, 2005.

## Impact on audit committees

The focus on restoring public trust in financial reporting has gone international. And along with new recommendations for companies, auditors, lawyers, investment bankers, standard setters, and regulators, come calls for greater board and audit committee involvement. How? Through active roles in monitoring ethical conduct, evaluating management performance, setting appropriate management compensation, communicating directly with internal audit, and assessing their own performance. International convergence of accounting and auditing standards is inevitable, with the European Union embracing global standards in 2005. And the sheer volume of companies that will be implementing the changes, as well as interrelationships between U.S. and European companies, mean U.S. companies will have to become conversant with—and, in some cases, apply—International Financial Reporting Standards. Foreign issuers accessing U.S. securities markets are facing new governance rules, many similar to those for domestic companies, with the only difference being a later implementation deadline for some rules. Audit committees need to recognize emerging accounting and other standards and the implications for their companies, and discuss with management how developments are being tracked and addressed.

The PricewaterhouseCoopers publication, *Audit Committees: Good Practices for Meeting Market Expectations*, 2<sup>nd</sup> edition, summarizes audit committee requirements in over 40 countries and related leading practices. The publication is available at [www.pwc.com/uscorporategovernance](http://www.pwc.com/uscorporategovernance).

# Developments affecting financial reporting

## Pro forma measures—new SEC rules

In January 2003, as required by Sarbanes-Oxley, the SEC issued final rules dealing with the use of non-GAAP financial measures, often called pro forma measures. Companies increasingly are using these measures, believing that GAAP results alone don't provide a full picture of a company's performance and future prospects.

The rules, which apply to companies that publicly release—in SEC filings or elsewhere—non-GAAP financial measures, include new requirements for disclosures in other than SEC filings, and amend several SEC forms. In addition, the rules require companies to furnish to the SEC, on Form 8-K, earnings releases or similar announcements. If non-GAAP financial measures are disclosed in those announcements, details of the non-GAAP measures are required. The rules don't apply to non-GAAP financial measures relating to proposed business combinations—for example, projections or forecasts of transaction results that are shared among principals and advisors. And exceptions and accommodations apply to registered investment companies and foreign private issuers.

### SEC filings

Under the rules, companies making SEC filings must:

- Present, with equal or greater prominence, the most directly comparable financial measure calculated and presented in accordance with GAAP
- Disclose a quantitative reconciliation of the differences between the non-GAAP and GAAP measures
- Provide substantive reasons why management believes the non-GAAP measure provides useful information to investors
- Describe any other reasons management uses the non-GAAP measure

Companies have flexibility in determining the “most directly comparable GAAP financial measure,” but the SEC believes non-GAAP measures of cash or liquidity should be balanced with cash flow amounts, and non-GAAP measures depicting performance should be balanced with net income or income from continuing operations.

The rules also prohibit certain practices in SEC filings:

- Excluding from non-GAAP liquidity measures any charges or liabilities requiring cash settlement, except for earnings before interest and taxes (EBIT) and earnings before interest, taxes, depreciation, and amortization (EBITDA), which by their nature exclude charges or liabilities requiring cash settlement
- Adjusting a non-GAAP performance measure to eliminate or smooth items identified as nonrecurring, infrequent, or unusual, when the charge or gain is reasonably likely to recur within two years, or did occur within the prior two years
- Presenting non-GAAP financial measures in financial statements prepared in accordance with GAAP or in the accompanying notes
- Using titles or descriptions of non-GAAP financial measures that are the same as, or confusingly similar to, those used for GAAP financial measures

### Disclosures in other venues

For non-GAAP financial measures disclosed in venues other than SEC filings, the company has to disclose, for each measure—both historical and prospective—the most comparable GAAP financial measure and a reconciliation of the two. The reconciliation—in the form of a schedule or other clearly understandable method—needs to be quantitative, unless such information isn't reasonably available for prospective measures. Companies that release non-GAAP financial measures orally, telephonically, in a webcast or broadcast, or by similar means can provide the required accompanying information on their website.

## New Form 8-K mandates

Companies now must furnish to the SEC a Form 8-K, within five business days of a public announcement or release disclosing material nonpublic information regarding results of operations or financial condition for an annual or quarterly period. These requirements apply even if the release or announcement doesn't include a non-GAAP financial measure.

## Effective date

The new rules became effective March 28, 2003 and apply to disclosures made after that date.

## SEC report on Fortune 500 corporate disclosure

As part of its review of financial and nonfinancial disclosures by public companies, the SEC screened the annual reports filed by all Fortune 500 companies in 2002. It then selected many of the reports for further review, focusing on disclosures that appeared to be critical to an understanding of a company's financial position and results, but that, at least on their face, seemed to conflict significantly with GAAP or SEC rules, or to be materially deficient in explanation or clarity. In February 2003, the SEC reported its comments, which concentrated on financial reporting, including both MD&A and financial statements. Some of the key areas covered:

**MD&A.** Many comments dealt with companies' MD&A. For the most part, they related to information presented in the financial statements that the SEC believed warranted more discussion in MD&A. This finding factored into the SEC's thinking when it issued the interpretive guidance on MD&A, as discussed in *SEC Focus*. Specifically, the SEC:

- Asked companies for greater analysis of their financial condition and results of operations, if they simply had recited financial statement information without analysis or presented boilerplate analyses that didn't provide insight into management's understanding of past performance or business prospects.
- Sought additional information about known trends, uncertainties, or other factors.
- Discouraged companies from providing rote calculations of percentage changes of financial statement items and boilerplate explanations of immaterial changes to these figures, encouraging companies to include instead a detailed analysis of material year-to-year changes and trends.
- Addressed liquidity, cash flow, and capital resources, when these topics were given insufficient attention.

**Critical accounting policy disclosure.** A substantial number of companies either didn't provide required critical accounting policy disclosure or provided inadequate disclosure. The SEC sought a more thoughtful discussion of assumptions and estimates—in such areas as revenue recognition, restructuring charges, impairments of long-lived assets, investments, and goodwill.

**Non-GAAP financial information.** The SEC asked companies to remove non-GAAP financial information that was misleading or susceptible to misinterpretation, or was presented too prominently or with inadequate explanation. Many companies gave limited prominence to and discussion of GAAP financial information. As discussed in a previous section, the SEC issued final rules for disclosure of non-GAAP measures in January 2003.

**Revenue recognition.** The SEC frequently requested that companies clarify how they recognized revenue and complied with SAB 101 (superseded by SAB 104 in December 2003, as discussed in a later section). The SEC also asked companies to expand significantly their related policy disclosures.

**Restructuring charges.** The SEC asked many companies to justify or explain more fully their accounting for restructuring charges and to expand their disclosure of restructuring charges in both their financial statements and MD&A.

**Impairment charges.** A significant number of comments focused on impairment charges:

- **Long-lived assets.** Many comments related to the timing, measurement, and disclosure of impairment charges, with the SEC asking why impairment charges weren't recognized in prior periods. The SEC asked companies to disclose in their MD&A material assets analyzed for impairment for which an impairment charge had not yet been recorded, and to expand both their financial statement and MD&A disclosures.

- **Securities held for investment.** The SEC asked companies to explain or justify how they determined that significant unrealized losses, over an extended period of time, were still considered temporary. It also asked companies to expand their MD&A to describe the specific factors used to determine whether unrealized losses were considered temporary or other than temporary.
- **Goodwill and other intangible assets.** The SEC asked companies about their goodwill impairment tests and their determination that intangible assets had indefinite lives, to revise their financial statements to reflect impairments, to more clearly describe their accounting policy for measuring impairment, and to provide missing disclosures required by FAS 142. Also, companies were asked to expand their MD&A to describe the methodology and assumptions or estimates used to test goodwill and other intangible assets for impairment, and to highlight any reporting units for which goodwill impairment charges were reasonably likely to occur.

**Pension plans.** Many comments dealt with the long-term expected return assumption for plan assets and other assumptions used in determining pension income or expense. The SEC asked companies about the basis for and the reasonableness of their expected return assumption, in particular given experience with negative stock market returns.

**Segment reporting.** The SEC found that many companies inappropriately aggregated operating segments, or didn't adequately explain the basis for aggregating information. Although not a new issue with the SEC, segment reporting has taken on increased prominence given its links to a company's goodwill impairment analyses.

**Securitized financial assets and off-balance sheet arrangements.** The SEC raised questions about how some companies described their sale of financial assets—accounts receivable, loans, and investment securities—through securitizations and how they determined they truly had surrendered control of the assets transferred, when there was evidence to the contrary. The SEC asked companies to expand their MD&A to describe the structure, business purpose, and accounting for these transactions, and to highlight the significant assumptions used to determine gains or losses. The SEC found similar issues and sought similar additional disclosures about off-balance sheet arrangements.

**Environmental and product liability disclosures.** The SEC commented on the environmental and product liability disclosures of companies in a diverse group of industries. The SEC urged companies with material contingent liabilities to carefully review their disclosures and ensure that they include all required information. It also urged companies to provide in their MD&A a meaningful analysis as to why the amounts charged in each period were recorded and how the amounts were determined.

### Continuing efforts

The SEC is assessing how Fortune 500 companies are responding to the comments from the 2002 review. In addition, Sarbanes-Oxley requires the SEC to review companies' reports at least once every three years, and the SEC has indicated it plans to review some companies every year.

For their part, audit committees will want to understand what comments, if any, the company received from the SEC's review, and how management has responded and is continuing to address them in upcoming disclosures and filings.

## Revenue recognition revisited

### EITF Issue 00-21

Following long deliberation, which began in 2000, the Emerging Issues Task Force finalized Issue 00-21, *Accounting for Multiple Element Arrangements with Multiple Deliverables* (Issue 00-21), early in 2003. It provides guidance related to how companies should recognize revenue under multiple element revenue arrangements that involve more than one deliverable—called “units of accounting” when the deliveries take place in different accounting periods. Previously, accounting guidance for such arrangements was provided by SEC Staff Accounting Bulletin 101, which was superseded in December 2003 by SAB 104, discussed below.

Issue 00-21 provides a set of guiding principles—as shown in the box—rather than prescriptive rules. It requires companies to make difficult judgments about which deliverables qualify as units of accounting. These judgments regarding the units of accounting will impact significantly the timing of revenue recognition. One such critical judgment is whether there is sufficient objective and reliable evidence of the fair values of the individual undelivered units of accounting. If there isn't, the revenue for an agreement with multiple deliverables will have to be allocated to fewer deliverables, and sometimes to

only the final deliverable. Issue 00-21 also states that separate contracts with the same company or related parties that are entered into at or near the same time are presumed to have been negotiated as a package and therefore should be evaluated as a single arrangement in considering whether they involve one or more units of accounting. Issue 00-21 includes examples of how various sets of facts and circumstances should be analyzed under its principles.

## Guiding principles of Issue 00-21

- Revenue arrangements with multiple deliverables should be divided into separate units of accounting if the deliverables meet all the following criteria:
  - the delivered item has value to the customer on a standalone basis
  - there is objective and reliable evidence of fair value of the undelivered items in the arrangement
  - if the arrangement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the vendor
- The arrangement's consideration should be allocated among the separate units of accounting based on their relative fair values—although specified circumstances allow other bases to be used
- Applicable revenue recognition criteria should be considered separately for separate units of accounting

Issue 00-21's coverage is limited to: (1) how to separate a multiple element revenue arrangement into its separate units of accounting; and (2) how to measure the total consideration and allocate it to each unit. It does not address such matters as when revenue for a unit of accounting is recognized, how much of the cost is allocated to each unit, and income statement classification. Further, Issue 00-21 does not address the accounting for any customer incentives such as rebates and discounts on the price of products and future purchases.

Issue 00-21 applies only if higher-level GAAP pronouncements don't provide guidance on separating units of accounting and/or allocating revenue to them. Therefore, to the extent there is higher-level GAAP regarding specific revenue recognition criteria, companies must apply those pronouncements prior to applying Issue 00-21. Issue 00-21 doesn't apply to arrangements that include vendor offers to customers or that involve the sale of award credits by broad-based loyalty program operators.

### SAB 104

SAB 104, *Revenue Recognition*, rescinds the provisions of SAB 101 dealing with multiple element revenue arrangements, but leaves other revenue recognition principles of the earlier SAB largely unchanged.<sup>13</sup> Highlights of SAB 104:

**Equipment sold on an as installed basis.** SAB 104 removes the option of recognizing revenue upon installation for equipment sold on an as installed basis. Accordingly, if equipment is deemed to be a separate unit of accounting under Issue 00-21, revenue should be recognized upon delivery. The revenue recognized upon delivery should be the lesser of the equipment's relative fair value or the amount not contingent on either delivery or performance of other units of accounting, assuming all other revenue recognition criteria in SAB 104 are met.

On the other hand, if equipment and installation are considered a single unit of accounting under Issue 00-21, revenue is deferred and recognized as the installation is performed, provided the installation is essential to the equipment's functionality. If not, only the portion of the fee related to the installation should be deferred and recognized as the installation is performed. The portion of the arrangement fee related to the installation is that portion of the fee that is withheld or contingent on performing the installation service.

**Inconsequential or perfunctory performance obligations.** SAB 104 establishes that revenue may be recognized in its entirety (assuming all other recognition criteria are met) if the seller has substantially completed or fulfilled the terms in the arrangement and the remaining obligation is inconsequential or perfunctory. But, for revenue to be recognized in these circumstances, any failure to complete the remaining obligations must not result in the customer receiving a refund or having a right to reject the delivered products or services already performed. For example, a remaining obligation would not be

<sup>13</sup> For a full discussion of SAB 101, see *Current Developments for Audit Committees 2002*, available at [www.pwc.com/uscorporategovernance](http://www.pwc.com/uscorporategovernance).

considered inconsequential or perfunctory if (1) it is essential to the functionality of the delivered products or services, or (2) a portion of the consideration is not payable until the service is delivered. If an obligation is not inconsequential or perfunctory, revenue for the unit of accounting generally would be deferred until the remaining performance obligation is complete.

### Disclosure requirements

Under Issue 00-21, companies should disclose their accounting policy for recognizing revenue from multiple-deliverable arrangements, along with a description of such arrangements. Companies also should consider the effect of SAB 104 on their revenue recognition policies—while understanding that SAB 104 does not result in a change in accounting principle.

### Effective date and transition

Issue 00-21 should be applied to revenue arrangements entered into in fiscal periods (interim or annual) beginning after June 15, 2003. If a change in accounting for arrangements already underway results, the company may elect to report the effect of the change as a cumulative-effect adjustment or may apply the new treatment prospectively. In either case, companies should provide clear and transparent disclosure of the effect of the change in the notes to their financial statements and, for SEC registrants, MD&A.

## Equity-based compensation

The FASB's ongoing project on accounting for stock-based compensation continues to be one of the most controversial and closely monitored projects in its history. Congress, the media, and companies are watching closely, a stark reminder of the debate that raged a decade ago during deliberations on FAS 123, *Accounting for Stock-Based Compensation*. The FASB is coordinating its standard setting with the International Accounting Standards Board, with the objective of achieving convergence on a single, high-quality global accounting standard for equity-based compensation (EBC). Both boards have made critical decisions that will have far-reaching implications for the way companies account for these types of instruments.

The FASB is completing its EBC project in phases. The first phase will address the accounting for EBC transactions with employees—other than employee stock ownership plans (ESOPs). The second phase will address accounting for ESOPs and EBC arrangements with nonemployees.

The FASB has made many of the principal decisions to be included in the exposure draft. In general, those decisions build on the principles in FAS 123, supplemented by additional guidance. If adopted, dramatic changes will result in how most companies account for EBC transactions with employees. The most significant changes would require companies to treat their employee EBC plans as an expense in the income statement beginning at the date awards are granted to employees. Additionally, after options vest, companies would not be permitted to reverse any recognized compensation cost.

### Transition and effective date

The proposed standard would require public companies to adopt a modified prospective transition method:

- For *vested* equity awards outstanding at the effective date, no additional compensation expense would be recorded, but companies would follow the settlement provisions of the new standard.
- *Unvested* equity awards outstanding at the effective date would continue to be measured and charged to expense over the remaining vesting period as required by FAS 123.
- All *new awards* granted after the effective date would use the measurement, expense recognition, and settlement provisions of the new standard.

If adopted, this proposed transition method would cause comparability issues, as some companies have adopted the income statement recognition provisions of FAS 123 rather than continuing to follow its disclosure provisions. For public companies, the proposed standard would be effective for fiscal years beginning after December 15, 2004—January 1, 2005 for calendar-year companies.

Nonpublic companies would follow a prospective transition method that would provide prospective expense recognition for all new awards granted, modified, or settled after the effective date, which would be delayed for one year, until fiscal years beginning after December 15, 2005.

An exposure draft on the first phase is expected during the first quarter of 2004. In addition, the FASB expects to hold roundtable discussions to better understand constituent concerns and gather feedback on the exposure draft. A final statement is expected before the end of 2004.

### Determining fair value

Companies have had a choice of which option-pricing model (e.g., the Black-Scholes or binomial models) they used to measure the fair value of EBC awards. Today, the vast majority of public companies use the Black-Scholes model to develop the information needed for the recognition or disclosure provisions of FAS 123. While the Black-Scholes model is simple to apply, critics argue it lacks flexibility in its assumptions—by requiring input factors to remain static over the life of the option—and often overestimates the fair value of EBC awards. Alternatively, the binomial model offers greater flexibility of the assumptions used, can be adapted for several inputs to reflect relevant circumstances, and generally results in a more accurate estimate of the fair value of options granted. But calculating fair values using a binomial model requires companies to (1) perform extensive data analysis to refine the assumptions included in the model (including tracking the correlation between employees' exercise behavior and the amount that the option is in the money); and (2) develop or purchase software to perform the complex binomial calculations. Thus, the binomial model is used less commonly, as companies historically have not kept the required data or performed the analysis necessary. But to the extent the FASB determines that the greater precision afforded by the binomial model is desirable and requires its use, companies may be obligated to start gathering such information and performing the analyses.

### International developments

The IASB's Exposure Draft 2, *Share-based Payment*, covers all share-based transactions—whether equity or cash settled—and includes transactions with nonemployees. The IASB has agreed with the FASB's views on using a modified grant date fair value methodology for recognizing compensation expense for EBC awards.

However, ED 2 differs from the FASB's tentative decisions in other areas, such as the accounting treatment of income taxes related to EBC awards. The effective date of ED 2 would be January 1, 2005, but comparative figures for 2004 and 2005 must be presented upon adoption of ED 2. The IASB expects to issue the final statement in the first quarter of 2004.

### Next steps

Management should start preparing for compliance with the forthcoming standard. Companies—and other interested constituents—should:

- Review the exposure draft upon its release
- Express their views to the FASB—in writing as part of the comment letter process and participating in the public roundtables
- Assess the potential impact on their stock option plans and determine what changes, if any, they should consider to their compensation strategies and financial reporting

## Purchase method procedures project

A few years ago, the FASB undertook a project to address accounting for business combinations. The first phase of that project resulted in FAS 141, *Business Combinations*, and FAS 142, *Goodwill and Other Intangible Assets*, both described in a prior publication.<sup>14</sup> The second phase—nearing completion—is intended to address the application of the purchase method of accounting.

To date, the FASB has tentatively agreed on or proposed several significant changes to practice:

- **Definition of a business combination.** The definition of a business combination will encompass acquiring control over a business through means other than acquiring net assets or equity interests. So, for example, companies will need to account for the lapsing or expiration of minority veto rights as a business combination. Accordingly, a purchase price allocation will need to be performed, and goodwill and intangible assets likely will be recognized.

<sup>14</sup> See *Current Developments for Audit Committees 2002*, available at [www.pwc.com/uscorporategovernance](http://www.pwc.com/uscorporategovernance).

- **Measurement date.** The measurement date for equity securities issued in a business combination will be the acquisition date as opposed to the “substantive agreement” date currently used.
- **Acquisition costs.** Direct costs of the acquisition—including investment banking, legal, and accounting fees—will be expensed as incurred.
- **Contingent consideration.** Contingent consideration will be initially measured at fair value and recorded on the acquisition date. Subsequent changes in fair value will be recognized in the income statement until the contingency is resolved, unless the contingent consideration qualifies as an equity instrument under FAS 150, described later in this section. This represents a change from current practice, which recognizes contingent consideration when the contingency is resolved and the contingent consideration becomes issued or issuable.
- **Preacquisition contingencies.** Similar to contingent consideration, preacquisition contingencies will be recognized on the balance sheet at fair value on the acquisition date. Any subsequent changes in fair value will be recognized in the income statement.
- **In-process research and development.** In-process research and development will be capitalized and amortized over their useful life, instead of being written off immediately, as is the current practice.
- **Restructuring activities.** Companies will not be permitted to record restructuring activities as assumed liabilities.
- **Goodwill.** The “full goodwill method” will apply to partial—less than 100%—business combinations. Under this method, the acquirer will record the entire fair value of the acquiree and recognize all the goodwill and intangible assets at 100% of their value. Minority interest will be recorded as part of equity. Transactions between the parent and the noncontrolling shareholders will be recorded as equity transactions. Current accounting practice for partial business combinations is to record the full fair value of the assets, including goodwill, and liabilities to the extent of the ownership interest acquired.

The FASB will complete its deliberations and issue an exposure draft outlining proposed changes in the first half of 2004. It's anticipated that the final standard will be effective for all business combinations occurring after January 1, 2005. The anticipated changes to current practice are significant and have important implications for companies anticipating deals. Companies negotiating deals during 2004—and audit committees and boards being asked to approve such mergers and acquisitions—will want to understand the accounting implications and consider the results of these changes when structuring deals and calculating deal economics.

## Derivative instruments and hedging activities—FAS 149

FAS 133, *Accounting for Derivative Instruments and Hedging Activities*—issued in 1998—was remarkably complex. To address its implementation issues, the FASB formed a working group, the Derivatives Implementation Group, or “DIG.” Over its five-year existence, the DIG considered hundreds of issues, many of them involving interpreting and applying the definition of a derivative. In April 2003, the FASB issued Statement No. 149, *Amendment of Statement 133 on Derivative Instruments and Hedging Activities*, which incorporates some of the issues the DIG addressed. It clarifies the definition of a derivative and fine-tunes the interpretation of scope exceptions in FAS 133.

### Scope exceptions

Many of FAS 149's provisions deal with transactions that are exempt from the scope of FAS 133, including certain security trades, financial guarantee contracts, life insurance policies, investment contracts, and loan commitments. The criteria for exclusion from or inclusion in the scope of FAS 133 are complicated, and those responsible for accounting for derivatives and related transactions will need to apply care when considering the specific products and the criteria in both FAS 133 and 149.

### Financing elements in derivatives

A significant provision of FAS 149 concerns identifying a financing element within a derivative. FAS 149 identifies two characteristics—up-front cash payments and off-market terms—often associated with a derivative that contains a financing element, but acknowledges that identifying a financing element is a matter of judgment depending on specific facts

and circumstances. It requires that if an “other-than-insignificant” financing element is present at inception, the borrower should report all associated cash inflows and outflows as financing activity in the statement of cash flows.

### Effective date

FAS 149 should be applied prospectively for contracts entered into or modified after June 30, 2003.

## Financial instruments with characteristics of both liabilities and equity— FAS 150

In May 2003, the FASB—concerned about the balance sheet classification of certain freestanding financial instruments—issued Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*.

The FASB identified three types of freestanding financial instruments as embodying a company’s obligations that must be classified as liabilities. They are:

**Mandatorily redeemable financial instruments.** These are instruments issued in the form of shares that unconditionally obligate the company to redeem them by transferring assets on a specified or determinable date, or upon an event that is certain to occur. Examples are preferred stock redeemable on a specified date and common stock redeemable on the holder’s death or retirement. The definition excludes instruments redeemable only on liquidation or termination of the issuer and contingently redeemable securities (e.g., redeemable upon an initial public offering).

**Obligations to repurchase the company’s equity shares by transferring assets.** These are contracts that require a company to repurchase its own shares or that are indexed to such an obligation. These obligations require—or may require—the company to transfer assets to the holder at contract settlement. Examples are written put options or forward purchase contracts for the issuer’s stock that require a physical or net cash settlement.

**Certain obligations to issue a variable number of shares.** Any obligations requiring or permitting settlement by the company’s issuing its own equity shares should be classified as liabilities if the company must or could settle the instrument by issuing a variable number of its equity shares, and the obligation’s monetary value is based solely or predominantly on any of the following at the instrument’s inception:

- A fixed monetary amount that is known at the instrument’s inception
- Variations in something other than the fair value of the company’s equity shares
- Variations inversely related to changes in the fair value of the issuer’s equity

### Initial and subsequent measurement

Forward purchase contracts that must be physically settled via repurchase of a fixed number of the company’s equity shares in exchange for cash should be measured initially at the fair value of the shares at the contract’s inception, adjusted for any consideration or unstated rights or privileges. All other financial instruments that fall within the scope of FAS 150 should be initially measured at fair value.

Subsequent measurement—of mandatorily redeemable instruments and forward contracts that fall under FAS 150 and must be settled physically via repurchase of a fixed number of the company’s equity shares in exchange for cash—should be done in one of two ways:

- If both the amount to be paid and the settlement date are fixed, the instrument should be subsequently measured at the present value of the amount to be paid on the settlement date, with interest cost accruing based on the rate implicit at the inception of the instrument. The stated dividend rate on mandatorily redeemable instruments generally should be accrued even if it is not declared.
- If either the amount to be paid or the settlement date varies as a result of specified conditions, the subsequent measurement should be based on the amount of cash—undiscounted—that would have been paid under the conditions specified in the contract if a settlement had occurred on the reporting date, with the change in amount from the previous reporting date recognized as interest cost.

All other instruments within the scope of FAS 150 should be subsequently measured at fair value.

Additionally, a number of new disclosures are required for outstanding financial instruments within the scope of FAS 150.

### Effective dates

For financial instruments entered into or modified after May 31, 2003, FAS 150 was effective immediately. For other instruments, except as noted below, FAS 150 went into effect at the beginning of the first interim period beginning after June 15, 2003. For contracts created or modified before May 31, 2003 and existing at the beginning of the first interim period beginning after June 15, 2003, companies should record the transition to FAS 150 by reporting the cumulative effect of a change in an accounting principle. FAS 150 prohibits restating financial statements for earlier years presented.

There are exceptions to the effective dates for mandatorily redeemable financial instruments of certain nonpublic entities and certain mandatorily redeemable noncontrolling (i.e., minority) interests, deferring application.

## Consolidation of variable interest entities—FIN 46

Early in 2002, in response to the accounting issues that surfaced following Enron's collapse, the FASB began a project on identifying and accounting for variable interest entities, and issued its financial interpretation, FIN 46, *Consolidation of Variable Interest Entities*, in January 2003. FIN 46 doesn't apply to not-for-profit organizations (except in certain situations), employee benefit plans, or registered investment companies.

FIN 46's objective is not to restrict the use of variable interest entities (VIEs), but rather to improve financial reporting where such entities are involved. Essentially, it directs companies with a controlling financial interest in a VIE, to include those assets, liabilities, and results of activities in their consolidated financial statements. The FASB's objective in issuing FIN 46 was to provide guidance to address situations where the "voting interest" approach is not effective in identifying a party that has a controlling financial interest in an entity. Therefore, in assessing VIEs, the existence of a controlling financial interest is defined in terms of risks and rewards rather than voting rights.

Under FIN 46, the primary beneficiary of VIEs consolidates them. The primary beneficiary is the party that absorbs a majority of a VIE's expected losses, receives a majority of its expected residual returns, or both, as a result of holding variable interests in it. These are new concepts and may not be intuitive. For example, expected losses are unfavorable variances compared with expected results, not necessarily actual losses. Thus, under FIN 46, a company could have expected losses through a relationship with an entity that is always expected to be profitable.

The ability to make decisions about a VIE does not in and of itself identify the decision maker as the primary beneficiary. However, fees earned by a decision maker in most cases would be a variable interest that would create both expected losses and expected residual returns, and therefore would influence the identification of the primary beneficiary.

FIN 46 is very complex, with broad implications. It applies to a range of variable interests (as defined in the Interpretation), which may include ownership interests, loans, leases, contracts, or other monetary interests in an entity that change in value with fluctuations in the entity's net asset value. FIN 46 essentially represents a new consolidation model that takes precedence over the voting interest model in all cases covered by its scope.

### Subsequent revisions

In December 2003, the FASB revised FIN 46 to address certain implementation issues. Among the changes, FIN 46-R:

- Clarifies the definition of a variable interest and provides examples to assist in identifying variable interests
- Eliminates the bias toward decision makers and guarantors of substantially all assets of the VIE by treating those interests the same as other variable interests in the entity
- Excludes certain situations where, after exhaustive effort, a company is unable to obtain information pertaining to a VIE that it would need in order to assess the entity or its relationships with the entity under FIN 46 or to consolidate the entity
- Provides a scope exception for certain entities that meet the definition of a business if specified criteria are met

- Clarifies that government entities are exempt from applying it, except in certain cases
- Provides a list of events that require a company to reconsider whether it's the primary beneficiary and whether an entity is a VIE
- Excludes troubled debt restructuring as an event that would require reconsideration of VIE status and the determination of the primary beneficiary
- Clarifies that, among the members of a related party group, the primary beneficiary should be identified by determining the member that is most closely associated with the entity, and provides indicators to help make that determination
- Provides that goodwill should be recognized in initially consolidating a VIE that is a business, but prohibits a company from reinstating goodwill that was written off in applying FIN 46 prior to this FIN 46-R change

## Effective dates

FIN 46 became effective for VIEs created after January 31, 2003 or in which a company obtained an interest after that date. For VIEs created before February 1, 2003, it applies in the first fiscal year or interim period beginning after June 15, 2003. In early October 2003, the FASB delayed that effective date to December 15, 2003.

FIN 46-R further deferred the effective date for VIEs acquired before February 1, 2003, other than special-purpose entities (SPEs), to the end of the first interim or annual period ending after March 15, 2004. For SPEs acquired before February 1, 2003, companies must apply FIN 46 at the end of the first interim or annual reporting period ending after December 15, 2003. FIN 46-R provided only a general definition of SPEs—which are a subset of VIEs—as entities whose activities are related primarily to securitizations or other forms of asset-backed financings or single-lessee leasing arrangements, and that previously would have been accounted for by applying the relevant accounting literature for such SPEs.

The structure for implementing FIN 46 and FIN 46-R is complicated, depending on how a company is classified. The implementation guidelines for public companies follow. Different rules apply for small business issuer public companies and nonpublic companies.

Public companies:

- Either apply FIN 46 or early adopt FIN 46-R at the end of the first interim or annual reporting period ending after December 15, 2003 (i.e., as of December 31, 2003 for calendar-year-end companies) for all SPEs created prior to February 1, 2003. If not early adopting FIN 46-R, a company must apply FIN 46-R to SPEs as of the end of the first interim or annual reporting period ending after March 15, 2004.
- Adopt FIN 46-R at the end of the first interim or annual reporting period ending after March 15, 2004 for all non-SPEs created before February 1, 2003. Companies may elect to adopt FIN 46 or FIN 46-R for non-SPEs as of the end of the first interim or annual reporting period ending after December 15, 2003.
- Either early adopt FIN 46-R or continue to apply FIN 46 at the end of the first interim or annual reporting period ending after December 15, 2003 for all entities (both SPEs and non-SPEs) created after January 31, 2003. For these entities, FIN 46 was applicable as of the date a company first became involved with the entity. If FIN 46-R is not early adopted, the company must apply FIN 46-R to post-January 31, 2003 entities as of the end of the first interim or annual reporting period ending after March 15, 2004.

## Impact on audit committees

Disclosure and transparency are again a major focus this year. The SEC issued disclosure requirements for non-GAAP measures in response to companies' growing use of these measures. And the SEC focused on the quality and clarity of financial statement and MD&A disclosures when it reported the results of its review of Fortune 500 companies' 2002 annual reports. On the accounting front, many hot topics from prior years continue to be front and center in rule making. Revenue recognition is one, with both the SEC—with an updated SAB—and the FASB—whose Emerging Issues Task Force issued guidance on recognizing revenue under multiple element revenue arrangements with deliveries in different accounting periods—weighing in. Another FASB project—on accounting for equity-based compensation—continues its closely

scrutinized work on this controversial subject, in conjunction with international efforts. And the FASB project on business combinations continues, which promises significant impact on how business combinations will be accounted for, possibly changing the terms and economics of some deals being negotiated now. The FASB revisited some other complex issues this year, with new pronouncements on derivatives—clarifying their definition and fine-tuning the interpretation of scope exceptions—and on variable interest entities, another hot topic post-Enron. Finally, the FASB issued a standard that specifies that certain freestanding financial instruments must be classified as liabilities, with potentially significant impact on many companies. Audit committees will want to discuss with management and auditors how companies are complying with the new accounting and disclosure requirements, and keep up-to-date on evolving issues and their implications for the company.



# Appendix A: Establishing complaint processes

The Sarbanes-Oxley Act requires audit committees to establish procedures for the receipt, retention, and treatment of complaints regarding accounting, internal accounting controls, or auditing matters—including procedures for employees' confidential, anonymous submissions. Commonly termed “whistleblower” provisions, these new rules likely will require as much, if not more, effort on the part of some audit committees as any other new audit committee responsibilities driven by Sarbanes-Oxley. Remember, in some of the recent scandals, internal staff voiced concerns. But the allegations did not always get reported to the audit committee on a timely basis. Thus, the requirement that audit committees now have direct involvement in this area increases the probability that inappropriate behavior and possible improprieties will come to light. Additionally, it's sound practice to inform audit committees of critical viewpoints or concerns about business practices or financial reporting being expressed by the media or analysts—even though such concerns may not be considered “complaints” under Sarbanes-Oxley.

So, how are committees complying? Often by a combination of leveraging processes currently in place for employee concerns, and establishing new processes for complaints from external sources.

## Complaints from employees

Many companies established anonymous whistleblower “hotlines” for employees in the 1990s in response to Federal Sentencing Guidelines provisions, and others now are introducing them. Some companies are using these hotlines to comply with aspects of the new requirements. Others are choosing not to leverage existing processes, but to outsource the process instead, sometimes out of concern for employee confidence in the process. Regardless, key decisions include:

- Practically, how should company management be involved? Although Sarbanes-Oxley calls for the audit committee to establish these processes, no one expects audit committee members to staff hotlines and take calls. Instead, audit committees should approve the policies, process, and framework established to deal with how issues are raised, escalated, and ultimately reported to the committee. Committees then must rely on someone within the company to carry out the process—review and sort complaints received; direct appropriate follow-up, on the appropriate timeline; and report to the audit committee. Committees need to have confidence in and be able to trust whoever takes on this role. The designee needs to possess integrity and the ability and confidence to do the job properly and transparently. Accordingly, audit committees should be directly involved in choosing—or at least approving—the company official(s) to oversee the process. What other qualities should audit committees look for? Discretion, maturity, vision, judgment, fair-mindedness, lack of bias, independence, good operational knowledge of the overall business, and the skill and qualifications to assess complaints properly. And the courage to take actions that, at times, could be difficult or could conflict with the wishes of senior executives. Some committees are selecting the compliance officer, the general counsel, the ethics officer, or the internal audit director to fill the role.
- Should the hotline be administered internally or externally? Ideally, it should be accessible 24 hours a day. So, if a 24-hour line doesn't exist currently, the first question is whether the company has the capability to handle calls 24-7. Global companies should consider how best to accommodate international employees, including providing appropriate language and translation capabilities. Especially if the decision is made to have an internal call center, companies should consider taking measures to ensure that calls from employees cannot be traced. Companies also must ensure that people who staff internal hotlines are properly trained in how to handle situations. While some companies provide for intranet reporting, there are possible concerns over system security—that the company may be able to trace the source of employee complaints. If employees don't trust that their complaints will be anonymous, they won't share concerns. Regardless of technology platform, the best processes provide anonymous complainants with a means of checking in at a later date to learn whether the company has opened an investigation or resolved the concern they reported, even though they may not be given details.

Alternatively, the hotline could be outsourced to an external firm to take and document calls, and report details and summaries to designated company personnel. A key advantage of outsourcing: It provides a measure of greater independence. This may encourage employees to report concerns they otherwise might not. If outsourcing is used, the audit committee will want to be satisfied with the due diligence behind the selection of the service provider, and with the levels of service, availability, and professionalism of the firm selected—and that complaints are maintained in strictest confidentiality and reported only to the appropriate individuals within the appropriate client company. And indeed, some audit committees choosing to use a third-party provider have that provider report complaints directly to them as well as to internal company personnel.

Additionally, it's vital that company policies protect employees who report concerns. First, Sarbanes-Oxley Section 806 bars a company or any company officer, employee, contractor, subcontractor, or agent from discharging, demoting, suspending, threatening, harassing, or discriminating against any company employee "whistleblower." But even more fundamentally, any retaliation or threatened retaliation against employees discourages other employees from raising their concerns.

### Complaints from outside the company

As well as a process for getting anonymous complaints from employees, Sarbanes-Oxley requires that processes be established to handle complaints received from outside the company. Different processes can be used for such complaints, as the requirement to provide for anonymous reporting applies only to employees. So logistically, the process for receiving such complaints may be simpler. Again, it can be administered internally or externally.

The process for receiving external complaints can take different forms. Some companies are establishing and publicizing a post office box to allow outsiders to write in with concerns. Others are setting up toll-free numbers. Still others are leveraging the Internet, providing e-mail addresses or forms that can be downloaded and submitted. Some companies are even establishing e-mail addresses for the audit committee itself, or for the committee chair. Each has unique advantages and drawbacks. So while the Internet facilitates communication, it also opens up the possibility of receiving significant amounts of junk mail or spam.

And while it's vital employees have faith in the process, it's just as important that companies demonstrate to external stakeholders that the complaint process is taken seriously. How? One way is to publish responses to FAQs—frequently asked questions—on the company website, for example, describing the process the company follows for receiving and addressing complaints. Another way companies demonstrate commitment to a robust process is to acknowledge complaints received. Prompt acknowledgment is important—a tardy reply might imply the company is ignoring the complaint, prompting the individual to complain publicly. Such replies, however, need to be handled carefully and are best limited to a concise acknowledgment of receipt, as discussed in more detail later. Why? First, because the company won't know the facts before investigating further, so it's simply prudent not to comment at the outset. Also, a longer reply inadvertently might admit to wrongdoing (when none may have occurred) and impose liability on the company.

Caution in responding is particularly vital when using e-mail. By its nature, e-mail's ease makes it tempting for the company to open a dialogue, and with its informality, people tend not to be as careful about the content of responses and may be more inclined to make an emotional reply. Both could cause legal or regulatory problems for the company. And there's another reason for caution. Companies don't want to run afoul of Regulation Fair Disclosure provisions, which prohibit selective disclosure of material information.

### Addressing complaints

Dealing with the sheer volume of complaints—both internal and external—that may result is a key challenge. Companies weighing their options point to how easy it is for someone without a serious concern to send a quick e-mail. The fear of being inundated with complaints may be overblown, but in this electronic age, only time will tell. Some companies are considering automated tools to track complaints, such as work flow technology to route complaints automatically to the right person. Such automation relieves someone from having to check the "mail box" regularly.

How are complaints handled? First, policies and procedures need to be established to guide action, and the audit committee needs to be comfortable with these procedures. Any hotline, even one established specifically for accounting and auditing issues, will receive complaints on a number of different issues. Accordingly, the first step is for the hotline administrator to determine whether the call relates to human resources issues, product issues, or other compliance issues, and forward those complaints to the appropriate department—HR or legal or ethics or customer service—for resolution. And, if accounting or auditing complaints meet certain criteria—for example, in terms of dollar size or type of complaint or involving senior management—protocols must ensure immediate reporting to the audit committee, which can then determine its appropriate level of involvement in directing any investigation and make decisions on engaging a third party, such as outside counsel, to conduct the investigation.

Those overseeing the process will need to take great care when sifting through the complaints. Although some may be spurious—lodged by disgruntled employees or those with a grudge against the company—other complaints may be substantive. But all must be followed up to some extent, although some will take literally only minutes to resolve. As investigations can cost hundreds of thousands of dollars—or more—applying sound judgment in determining which complaints merit a closer look, and which merit a full-blown investigation, is critical. Accordingly, audit committees need to ensure the

right person is assessing complaints, using an established process and criteria for analyzing merit. Ideally, the process and criteria will help avoid the major risk of a valid complaint being dismissed with little follow-up.

Additionally, the audit committee will want to work with legal counsel to be comfortable that the company is properly addressing the issue of retaining records of calls and e-mails.

### Reporting to the audit committee

Any material complaints received should be reported to the committee on a timely basis, so the committee—or another group of board-level directors—can direct the investigation. What defines a material complaint? It could be one that meets a certain dollar threshold—as agreed on with the audit committee—or one related to sensitive subject matter (e.g., trading operations in a financial institution), or one that could be serious from an ethical viewpoint, or one involving senior management.

In the absence of a material complaint, different reporting options may be suitable. Some committees receive reports with the details of all complaints, how they were followed up, which ones were tagged for further investigation, and the results of the investigations. Others are getting a summary of complaints and the outcome of any investigations, with all details maintained for the committee to review at its discretion. In terms of timing, some committees are getting these reports semiannually, some more frequently, depending in part on the volume and nature of information. And despite the level of summarization a committee chooses to receive, it's a good idea for committees to understand overall results—for example, how many complaints were received this month from employees, how many from outside the company, the number of each resolved, and the number still under investigation.

During the first few years of compliance, many committees will want to receive relatively more detail, more frequently, as they embrace responsibility for this new process. Committees also need information about the process itself, allowing them to determine whether the “intake,” assessment, and investigation functions are adequate.

Of course, many committees want to monitor the type and volume of complaints received on HR and product quality issues, as such information helps them monitor company ethics and assess the reasonableness of warranty provisions and revenue recorded. Indeed, to the extent an audit committee has responsibility for overseeing ethics and compliance issues, summaries and significant items in these areas would be reported in any event. Such information typically is provided in the course of quarterly or semiannual reporting on trends and remediation. Regardless, receiving a summary—at least annually—of all nonfinancial complaints may give the audit committee important information on emerging business issues.

### Investigations

Lastly, what should audit committees do if investigations indicate genuine problems? Fundamentally, committees need to take charge, to act quickly and decisively, and to have the courage, when necessary, to challenge what they're hearing. Key is to work with experienced securities counsel and the auditors to manage the issue through required channels with regulators, as circumstances require. But beyond addressing securities law requirements, if senior-level fraud or other misconduct is found, the audit committee or board must determine disciplinary action and what remediation measures are needed. Additionally, the board will have to manage company reputation issues, oversee any settlement with regulators, resolve any shareholder suits, reassure employees, work with legal counsel and human resources to address any severance issues with departing management, and find replacement managers. All actions involve special stress and require greater board involvement. All should be contemplated in a crisis plan the board can use to direct its activity. Having such protocols in place ahead of time is invaluable, as it allows the board to hit the ground running, having identified who will take the leadership role and what path the board will follow.



# Appendix B: The COSO integrated framework—enterprise risk management

A board of directors plays a critical role in setting strategic direction. It works with management to consider opportunities and threats in the marketplace, weigh the company's strengths and weaknesses, and then develop appropriate courses of action.

Such activities link closely to the board's oversight of enterprise risk management. The board needs to understand how uncertainties may impact the company—either as barriers to leveraging new opportunities or as impediments to achieving strategies and objectives. And it's vital the board be comfortable that management has identified all relevant risks and is responding to them appropriately.

Traditionally, boards have concentrated on ensuring they understand the most significant risks and on knowing whether management is responding appropriately. However, since often most boards are unaware of management's processes for identifying such risks, they can't be confident all significant risks facing the company are identified. And it's these unknown and unexpected risks that have so devastated many companies in the scandals and failures witnessed over the past few years. In essence, boards have struggled with how to assess whether management has an effective enterprise risk management process.

That's changing. In 2003, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) published its exposure draft Enterprise Risk Management Framework,<sup>15</sup> written by PricewaterhouseCoopers. This Framework provides definitive guidance and a common basis for all parties involved to use in evaluating and improving enterprise risk management.

So what is enterprise risk management? According to COSO, it's a process, effected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risks to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.

## An overview of the framework

The Framework sets forth the principles that are fundamental to effective enterprise risk management. The first of these is that a company identifies and assesses risk in the context of its objectives. Second, enterprise risk management encompasses the presence and functioning of eight interrelated components throughout the entire company. The eight components are described in the box.

<sup>15</sup> A copy of the COSO Enterprise Risk Management Framework is available at [www.erm.coso.org](http://www.erm.coso.org).

# Enterprise risk management framework components

**Internal environment.** The internal environment is the foundation for all other components in the framework. It includes the risk management philosophy, the risk appetite, and risk culture management established. It also comprises a company's ethical values, personnel competence and development, management operating style, and assignment of authority and responsibility. Boards too play a critical role in the internal environment.

**Objective setting.** Management needs a process to ensure objectives are consistent with the company's mission and vision, link to overall strategy, and align with the company's risk appetite. These objectives should then be cascaded through the company and need to be clearly articulated so events potentially affecting their achievement can be identified and related risk tolerances established. Objectives can be established for many categories—common ones are strategic, operational, reporting, and compliance.

**Event identification.** As events unfold, they have an impact on whether a company achieves its objectives. But management can't always predict with certainty which events will unfold, when, or their outcome. Thus, management needs a process to identify events, as well as external and internal factors that affect event occurrence. External factors include economic, business, natural environment, and political, social, and technological factors. Internal factors include such things as infrastructure, personnel, process, and technology.

**Risk assessment.** Risk assessment allows a company to consider how potential events might affect achieving its objectives. Management assesses events from two perspectives: likelihood and impact. Likelihood is the possibility that a given event will occur, while impact is its effect if it occurs. Changes over time can alter both the likelihood and impact of an event, so care is needed when using past events to predict the future.

**Risk response.** Management considers different options in responding to the risks it has assessed—also bearing in mind risk tolerances and costs versus benefits—and designs and implements an appropriate response. The alternatives:

- Avoiding risk, possibly through exiting the activities that give rise to it
- Reducing risk likelihood or impact, or both, for example, by reducing reliance on certain customers or regions
- Sharing risk likelihood or impact by transferring or otherwise shifting a portion of the risk, commonly through insurance or hedging
- Accepting risk by not taking action to affect its likelihood or impact

In considering the risks and responses to various risks, management forms a portfolio view of its risks.

**Control activities.** Control activities are the policies and procedures that help ensure risk responses are properly executed. They occur throughout the company, at all levels and in all functions, and are part of the processes used to achieve business objectives. And they usually involve two elements: a policy establishing what should be done and procedures to effect the policy.

**Information and communication.** Companies need to ensure that pertinent information—from internal and external sources—is identified, captured, and communicated in a form and timeframe that enable employees to detect and respond to risks. Effective communication also needs to flow down, across, and up the company, and relevant information must be exchanged with external parties—customers, suppliers, regulators, and shareholders. And this should include information on risks. Effective information systems are vital to source, capture, process, analyze, and report relevant information.

**Monitoring.** Monitoring ensures all components of enterprise risk management are present and functioning effectively over time. Monitoring is often effected through ongoing activities, built into operating processes and performed on a real-time basis. This monitoring can be supplemented with separate evaluations, conducted after the fact. Generally, this combination of both ongoing monitoring and separate evaluations is most effective.

What's different about enterprise risk management from the means historically used to address a company's risks? It's that it is ongoing—not a snapshot in time, but an evolving process that continually incorporates new information into business decisions. It also provides a means to integrate performance management and risk management, which enhances a company's ability to achieve its objectives.

### Key roles and responsibilities for enterprise risk management

Fundamentally, everyone in a company has responsibility for enterprise risk management. But the board and management perform an especially vital role.

For its part, the board plays a central role in setting expectations for integrity and ethics, by selecting management. Board oversight then should ensure management continues to meet those expectations. Similarly, by reserving the authority for certain key decisions, the board plays a role in setting strategy, formulating high-level objectives, and allocating resources. And it oversees enterprise risk management by:

- Knowing the extent to which management has established effective enterprise risk management
- Being aware of and concurring with the company's risk appetite
- Reviewing the portfolio view of risks and considering it against the risk appetite
- Being apprised of the most significant risks and assessing whether management is responding appropriately

From a management perspective, the CEO is ultimately responsible for and should "own" enterprise risk management. The CEO plays a key role in setting the "tone at the top," by providing leadership and direction to senior managers and reviewing how they manage the business. Senior managers, in turn, assign responsibility for establishing specific risk management policies and procedures to those in individual business units. In addition to this hierarchy, staff functions such as compliance, finance, human resources, and information technology cut across the organization and contribute to determining risk responses, setting standards of control, and monitoring.

With the comment period for the draft report over, the authors are reviewing the Framework and considering revisions. The final Framework and associated guidance will be released in 2004. Application Guidance will provide illustrations of how organizations may apply the principles and concepts set forth in the Framework.



# Appendix C: XBRL update

For the past several years, this publication has described the development of an open, royalty-free, software-neutral information standard designed specifically for business reporting—eXtensible Business Reporting Language. XBRL represents the collaborative effort of a not-for-profit consortium of over 250 companies and agencies from around the world—working on a way to represent business information for use within companies’ internal information systems and between companies and their stakeholders, via Web services Internet transport standards. The goal is to enhance information availability, integrity, cost-effectiveness, and reusability by management and all other corporate reporting supply chain participants—including investors, creditors, regulators, and accountants. The year 2003 has seen a wide range of organizations recognize the benefits of XBRL and Web services, with the number of adoptions and pilot programs accelerating around the world.

## XBRL and Web services—a refresher

XBRL standardizes the definitions that govern business-reporting data. Web services enables the data to be exchanged securely. Combined, XBRL and Web services allow different software to share and process business information. Allowing different software platforms to “interoperate” reduces or eliminates the need for manual data-gathering and aggregation tasks. Instead, users focus on what the information is, rather than on finding its physical location within a particular data warehouse, software application, or document. Automated reporting, by replacing inefficient manual processes, makes information readily accessible to management, analysts, and others.

## Marketplace growth

The software community continues to embrace XBRL and Web services and incorporate them into a broad range of applications. Indeed, a 2003 study shows that in the United States, two-thirds of accounting software vendors have XBRL-enabled at least one of their products or will do so by December 2004. These vendors include the giants—Oracle, Microsoft, Hyperion, SAP, PeopleSoft, ACCPAC, and Fujitsu—and dozens of others. The study indicates they believe they’ll see increased demand for XBRL functionality from within the business-reporting and accounting communities.

With many software solutions now incorporating XBRL and Web services, companies, regulators, and other supply chain participants worldwide are using or considering these standards to streamline their reporting and analytical processes. A number of organizations publicly announced XBRL plans during 2003; a partial list appears in the box. This list will expand over the coming year as other organizations in early evaluation stages move forward into full-scale adoption.

## Organizations announcing XBRL plans

### Stock exchanges

KOSDAQ – Korea  
Luxembourg Stock Exchange  
New Zealand Exchange  
Schezhen Exchange  
Tokyo Stock Exchange  
Toronto Stock Exchange

### Tax authorities

Australian Tax Office  
Dutch Tax Authority  
The Irish Revenue  
National Tax Agency of Japan  
UK Inland Revenue

### Central banks and bank regulators

Banco de Espana  
Bank of Japan  
Bundesbank  
UK Financial Services Authority  
United States Federal Financial Institutions Examination Council (the FFIEC includes the Federal Deposit Insurance Corporation, or FDIC, and the Federal Reserve)

### Other authorities

Danish Commerce & Companies Agency  
Dutch Water Authority  
National Association of Insurance Commissioners (United States)  
Patent and Registration Office (PRV – Sweden)

The importance of regulatory adoption shouldn’t be underestimated. The FFIEC, which includes the FDIC—the U.S. government agency that insures bank deposits—is implementing XBRL to collect, manage, and distribute reporting by its member banks. It intends to require all 8,500 of them to use XBRL when submitting their monthly “call reports.” And while the FDIC’s move will force a cascade of XBRL adoption by member banks, it’s also having a domino effect on XBRL adop-

tion by other financial regulators around the world. In addition, a number of European regulators are considering mandating XBRL for IFRS reporting.

## Deciding to implement XBRL

Companies typically have many different, incompatible information systems, making it challenging to locate and consolidate information for internal and external reports. Thus, producing reports requires manual processing—which is time consuming and prone to human error. And the longer it takes management to get the reliable information it needs, at the right level of detail, the longer it takes to identify and correct any performance issues.

One solution is to eliminate most manual processing by automating—allowing analytical or reporting software to access information at its source. Data warehousing or systems consolidations can help, but these solutions take years to implement and can make it more difficult to check the information back to the source.

An alternative to using standardized technology like data warehouses is to standardize the information itself. This approach can improve data quality and accuracy, facilitate data exchange between different systems, and enable information to be reused instantly. It also means future technology changes will have less impact on the integrity and speed of information flows.

By using XBRL and Web services to standardize data, companies can tap information directly at its source whenever needed, thereby improving—or even entirely reengineering—reporting processes. For example, management can review details about individual subsidiaries' performance, rather than aggregated summaries. Thus, head office management can monitor a subsidiary's performance without being constrained by information "silos" at the business unit level. XBRL and Web services together allow standardized internal data to travel from source systems to any monitoring software—as long as that software also has XBRL and Web services capabilities.

To grasp the benefits of XBRL and Web services, consider the following questions:

- Is information kept in different systems and business units? How readily available is it for analysis and decision making?
- Do all business units follow standard policies and procedures and report consistently, or are many employees manually handling information at various levels?
- Is business reporting efficient, cost-effective, timely, and automated, or is there a significant amount of manual "cutting and pasting" and rekeying?
- Are the employees who collect, aggregate, and report information adding value to the business reporting processes?
- What level of confidence does management have that all information being produced and disseminated is accurate and reliable? What are the costs in time and effort to achieve this level of confidence?
- Do the early results of Section 404 readiness work indicate that controls around accumulating and summarizing corporate information warrant improvement? Could failing to improve such controls result in a possible weak link in internal control?
- How effectively can external stakeholders obtain, assess, and analyze the information provided to them?

If the answers point to a significant reliance on manual data-gathering processes, then XBRL and Web services could provide considerable benefit. As technology—particularly Internet standards—increasingly shapes how companies gather and report information, and with XBRL and Web services adoption growing rapidly, it's important companies understand these developments.

## Moving ahead with XBRL and Web services

Audit committees need to be confident that information flowing into key financial reports is accurate and reliable. If current reporting processes require a high degree of manual intervention, audit committees need to ask management how these issues are being addressed.

For more information on XBRL and Web services, see [www.xbrl.org](http://www.xbrl.org) and [www.pwc.com/xbrl](http://www.pwc.com/xbrl).



