



AUDIT COMMITTEE INSTITUTE

# *Audit Committee Insights* 2005 Annual Digest

KPMG INTERNATIONAL



# Contents

## Welcome

## Sarbanes-Oxley

- 2 Is Little Ventured without Sarbanes-Oxley Gained?
- 4 Deadline Forces Audit Committees to Confront Section 404
- 7 S-O Compliance Costs Turn into Business Benefit
- 10 S-O Compliance Playing Big Part in Next M&A Wave
- 13 Whistleblower Communication Recipe Calls for a Good Filter

## Financial Reporting

- 17 Principally Speaking, Standards Need Rules
- 20 XBRL: The New Acronym in Financial Oversight Lexicon

## Regulations

- 23 Beware of the Fine Print in Those Forward-Looking Statements
- 26 Audit Committees Take Aim at Fraud
- 29 Forensic Accounting Pieces Together Fraud

## Personnel

- 32 Audit Committee Financial Literacy: It's Not Just for the Experts Anymore
- 35 Becoming a Committee Member Isn't What It Used to Be
- 38 Message to Board: Find Out What's in Your D&O Policy Before It's Too Late
- 41 Independent Audit Committee Could Be Proxy Target

## **Register for KPMG's Audit Committee Insights**

KPMG LLP (U.S.) distributes a biweekly electronic publication to help audit committee members, executives, and others stay up to date on the ever-increasing volume of news, opinions, research, and trends related to corporate governance and the role of the audit committee. KPMG's *Audit Committee Insights* contains relevant articles selected from hundreds of sources on such topics as financial reporting, audit committee surveys, and shareholder issues. It also features articles offering KPMG's commentary, perspectives, and insights on key issues leveraging the knowledge gained through KPMG's Audit Committee Institute. Registration for this complimentary electronic publication is available at [www.kpmginsights.com](http://www.kpmginsights.com).

# Welcome to the *Audit Committee Insights* 2005 Annual Digest

Today's audit committee members face a difficult task in overseeing a company's financial reporting process. Legal and regulatory reforms, heightened stakeholder expectations, and shifting business imperatives have changed the corporate governance environment—and the audit committee's role, responsibilities, and accountability. Now there's a valuable resource to help you meet this need—at no cost to you. More than 12,000 board members, executives, and other financial reporting professionals rely on KPMG's *Audit Committee Insights* to help them stay abreast of evolving audit committee practices and issues.



*Audit Committee Insights*, a biweekly electronic newsletter, can help you stay current on the ever-increasing volume of news, opinions, and research related to corporate governance and the audit committee. *Audit Committee Insights* contains high-impact articles, selected from hundreds of publications, on Sarbanes-Oxley, regulatory developments, financial reporting, audit committee surveys, shareholder issues, and more. In addition, *Audit Committee Insights* features KPMG's commentary articles that leverage the insights of KPMG's Audit Committee Institute. Registration for this complimentary electronic publication is available at [www.kpmginsights.com](http://www.kpmginsights.com).

Based on numerous requests, we've now introduced another valuable resource to help you consider current audit committee challenges. The *Audit Committee Insights* 2005 Annual Digest is a compilation of key KPMG commentary articles published in *Audit Committee Insights* over the past year. Our new Digest provides yet another opportunity to get in-depth perspectives on key audit committee issues and emerging practices.

We also invite you to access KPMG's Audit Committee Institute (ACI) and its many resources. ACI has been informing and assisting audit committees since its formation in 1999. Our programs have allowed us to meet directly with thousands of directors and officers. ACI's initiatives include semiannual roundtables, numerous publications, conference and board presentations, a toll-free hotline, and periodic distribution of time-sensitive information.

Please visit us on the Web at [www.kpmg.com/aci](http://www.kpmg.com/aci). ACI also can be reached toll-free at 877-KPMG-ACI (877-576-4224) or via e-mail at [auditcommittee@kpmg.com](mailto:auditcommittee@kpmg.com).

Kenneth Daly  
Executive Director  
KPMG's Audit Committee Institute



## SARBANES-OXLEY

# Is Little Ventured without Sarbanes-Oxley Gained?

**By Christopher Westfall, Contributing Editor, *Audit Committee Insights***

Private companies still in the venture funding phase are struggling with implementation of the Sarbanes-Oxley Act of 2002 (S-O). But just how and when to jump on the corporate governance bandwagon is still up for debate.

Some industry observers feel that private companies at the venture capital stage should implement S-O in order to avoid a last-minute compliance scramble, or risk scuttling an initial public offering (IPO) or acquisition.

And some argue that S-O compliance should be more about governance than IPO concerns.

“The concept of good governance is what should really drive this,” says Mark C. Terrell, executive director of KPMG’s Audit Committee Institute, about private venture capital-stage companies embracing S-O.

Others argue that any private, venture-stage company that adopts S-O takes away precious cash—not to mention management, board, and audit committee time—when resources are needed most.

So while applying S-O standards is a *fait accompli* for many companies, how and when to do it for a private operation in the venture stage is unclear. “There is a real cost—the dollars that are spent—and then there is the management time [to implement S-O],” says Thomas Hartman, a Washington, D.C.-based partner with the law firm Foley & Lardner.

Because the ultimate goal of many start-ups is either an initial public offering or sale to a public company, they will eventually be required to fully adopt the S-O rules, Hartman says.

Many have already started. According to a survey conducted by Foley & Lardner, 60 percent of private firms responding have already implemented some aspects of the S-O legislation. The three most common parts of S-O adopted were CEO-CFO financial statement attestation (44 percent), board approval of non-audit service by auditors (43 percent), and establishing whistleblower procedures and corporate governance policy guidelines (40 percent).

But a number of private companies have become particularly involved when it comes to implementing the internal controls of section 404 of S-O, Hartman explains.

Putting together a solid internal control system is the main reason private companies looking to go public or get acquired should begin implementing S-O—particularly section 404—early on, Hartman argues. “Deals will not get done, or not get done in time, because of the lack of internal controls,” he says.

He also points out that other aspects of S-O, such as finding quality independent directors, take a great deal more time than many venture-stage companies anticipate.

But some aren’t so sure about getting a leg up on S-O; they view the requirements as too burdensome on small private companies. “We will think about these issues at the time we go public,” says Ravi Chiruvolu, a general partner with Charter Venture Capital in Palo Alto, Calif.

“I see Sarbanes-Oxley essentially as a regressive tax, where the smaller companies that are less able to pay for it bear most of the burden.”

Chiruvolu, who sits as a board member on eight small tech ventures (including several audit committees), says that the internal controls called for by the law may be redundant for smaller companies and that vendors looking to sell section 404 software are taking advantage of a panic.

Chiruvolu says that small companies can put in place adequate, pared-down controls without sacrificing the soundness of the company, while still being able to react in time for a liquidity event. “There is a whole ecosystem of software providers that look to automate [section 404], but they don’t necessarily work in a small company environment.”

Small companies should carefully consider their approach as they may run the risk of putting in place systems that may fall out of favor as S-O rules are solidified. “It’s still early,” Chiruvolu says.

But Hartman warns that although regulations could be changed and the cost of S-O implementation is high, being cavalier about implementation could end up costing a venture-stage company heavily—multiples of the cost of compliance.

“Every company should be looking at Sarbanes, assessing what they need to do to document internal controls,” Hartman says. “In the end, it shouldn’t be that hard.”

*Originally published July 28, 2004.*

**While S-O standards are a fait accompli for many companies, it’s unclear how and when to apply the standards for private, venture-stage operations.**



## SARBANES-OXLEY

# Deadline Forces Audit Committees to Confront Section 404

By Gary Larkin, Managing Editor, *Audit Committee Insights*

Just as corporations faced huge Y2K issues, audit committees face a monumental deadline to avoid major headaches.

The task? Companies must ensure by December 31 that management and external auditors are able to assess internal control over financial reporting, in accordance with section 404 of the Sarbanes-Oxley (S-O) Act. The job may also call for audit committees to assert themselves when management and external auditors consider the differences between a control deficiency, a significant deficiency, or a material weakness.

“The audit committee has to make sure management has an appropriate deadline to deal with this thing—that deadline is rapidly approaching,” said Professor Charles Elson, director of the John L. Weinberg Center for Corporate Governance at the University of Delaware. Elson addressed a recent KPMG 404 Institute Webcast on the topic of section 404 oversight by audit committees.

Under section 404, management of public companies that issue year-end financial reports (10-Ks) to the Securities and Exchange Commission after November 15 need to sign a statement saying they are responsible for the internal control structure for financial reporting, and provide an assessment of the effectiveness of that system.

“Is management ready? Will they do all they can to make the deadline?” asks Robert Lipstein, partner in charge of KPMG’s S-O 404 Services. He says it is paramount that audit committees understand the nature and extent of a deficiency, as well as the remediation process.

That’s why Lipstein touts the need for communication. “You can’t have enough [communication],” he says. “We believe an audit committee and auditors should be meeting regularly, even monthly or more frequently in certain cases before the end of this year.”

But in order for those meetings to improve financial reporting, Elson says that the audit committee has to make sure management gets help from the internal auditor and outside third parties as needed.

“They have to make sure a plan is in place and that appropriate staffing and funding is available,” said Elson, of counsel with Holland & Knight and chairman of the nominating and corporate governance committee for Auto Zone.

Elson said audit committees should consider how to incorporate oversight of internal control into meeting agendas, so that the process is ongoing rather than once a year. He also said some committee members might need a primer on section 404.

Dr. Walter Robb, chairman of Mechanical Technology Inc.’s audit committee and a member of Celgene Corp.’s audit committee, says the boards he sits on are using the internal auditor or an outside consultant to help oversee section 404 compliance.

“In one case, the process is being led by the independent auditor, [which] gave us a 15-page PowerPoint® presentation on how they will be checking the process in place,” Robb says. “They are consulting with the CFO and the internal auditor.”

In public statements this year, Public Company Accounting Oversight Board (PCAOB) Chairman William J. McDonough has pointed out the importance of the audit committee to the internal control assessment process.

“Longstanding frameworks for internal control make it clear that the audit committee is an integral part of the control environment,” McDonough told the Exchequer Club of Washington, D.C.

The SEC in June approved the PCAOB’s Standard No. 2, which applies to an audit of internal control over financial reporting done in conjunction with a financial statement audit.

PCAOB, created under S-O to oversee independent auditors, breaks down the types of issues identified in the assessment of internal control over financial reporting as a control deficiency, a significant deficiency, or a material weakness.

The standard states that a control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect misstatements in a timely manner.

It defines “significant deficiency” as a control deficiency that affects the financial reporting process to the degree that there is a “more than remote likelihood” that a misstatement of annual or interim financial statements “that is more than inconsequential” will not be prevented or detected.

In turn, a material weakness is one or more significant deficiencies that result in “more than a remote” likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected.

Ineffective oversight of a company’s internal control over financial reporting by the audit committee is “one of those deficiencies that is preordained to rise to a pretty high level,” Lipstein says. Citing PCAOB Standard No. 2, he notes such a situation is deemed a significant deficiency and a strong indicator of a material weakness.

According to an ongoing study of public company filings with the SEC, *Compliance Week* reported there were 320 disclosures in company 10-Qs and other public filings as of August. More than three fourths of the problems disclosed had to do with financial systems, procedures, and personnel.

*Compliance Week* also reported internal control disclosures from June–August make up 40 percent of the total, with 92 being filed in August alone.

In the first year of compliance, KPMG’s Lipstein says that many different companies will come to the same conclusion: “Companies should expect deficiencies,” he says. “Many will have significant deficiencies and some will have material weaknesses.”

As these disclosures and opinions from external auditors show up in SEC filings, the question of new risk and liability for companies, management, and possibly directors may be tested and further defined.

Elson cited the *Caremark International* health care provider settlement approval by the Delaware Court of Chancery in 1996.

**Observers say audit committees have to make sure management gets help from the internal auditor and outside third parties as needed.**

“The board [at that time] was not obligated under the law to ensure that an internal control process was in place,” Elson says. “That all changed with the *Caremark* case.”

The decision indicated that the board of directors is responsible for ensuring management has established internal control, not just internal control over financial reporting, according to *Audit Committees: A Guide for Directors, Management and Consultants*, a book on the workings of audit committees.

“*Caremark* showed that there would only be liability if the board did nothing,” Elson says. “That decision has created a compliance cottage industry.”

*Originally published October 6, 2004.*

**SARBANES-OXLEY**

## S-O Compliance Costs Turn into Business Benefit

With the deadline for Sarbanes-Oxley (S-O) section 404 coming and passing, audit committees need to help ensure their companies integrate new internal control oversight processes to achieve the benefits of the massive undertaking.

“The biggest concern is that [audit committees, internal audit, and management] are going to get complacent,” says Professor Glen L. Gray in the College of Business and Economics at California State University at Northridge. Gray has conducted a study with the Institute of Internal Auditors on the changing role of internal audit in the new S-O environment.

“This year created excitement with [S-O 404] teams getting things off the ground,” he says.

Gray says the novelty of meeting the initial deadline will soon wear off. For audit committees, that means it’s important to encourage management to reassess their approach to internal control documentation and assessment as needed. Companies should strive to achieve benefits from their S-O 404 efforts, weaving those internal controls and processes into their existing management systems.

KPMG 404 partner in charge Robert Lipstein says audit committees should be asking themselves several questions going into 2005, when their companies are required to report material changes related to financial reporting on a quarterly basis.

What happens when key people leave? What happens when the process gets improved? What happens when internal control systems get changed? What happens when businesses get sold and acquired? What happens if processes are outsourced?

Audit committees, Lipstein says, should be getting answers quickly, so they can meet regulatory disclosure deadlines.

The chief compliance officer (CCO) of a New Orleans broker-dealer has seen a big hit to his firm’s bottom line due to compliance expenses. But there has been an indirect payoff.

Pan-American Financial Advisers has had a 50 percent to 65 percent increase in compliance costs over the last year. Most of the company’s compliance concerns don’t deal directly with S-O, but rather with new regulations of the National Association of Securities Dealers as well as the SEC, according to Pan-American CCO Louis C. Passauer.

“The cost of compliance has been beneficial to firms of our size in an indirect way,” Passauer says of his firm, which has 200 registered representatives. “A lot of smaller one-person [broker-dealer] firms are [affected] so much they can’t stay in business. The day of the Mom and Pop shops are about over.”

One audit committee chairman cites the pre-approval process with the external auditor as one way in which an audit committee can control compliance costs.

“The audit committee is the external auditor’s client,” says Mike Morrissey, audit committee chairman for public companies FerrellGas Partners LP of Overland Park, Kan., and Westar Energy of Topeka, Kan., as well as for privately held Dunn Industries. “We sit down at the beginning of the fiscal year and approve [audit] fees at a certain dollar amount.”



**For audit committees, it's important to encourage management to reassess their approach to internal control documentation and assessment as needed.**

Morrissey says that certain infrequent events—such as a shelf registration—incur additional costs, requiring the audit committee to meet in consultation with management to approve any additional expenses.

At least two recent studies have found that many executives think 404 compliance costs are much too high, and many CEOs have been surprised by the resources they've devoted to S-O compliance.

“For some people, the cost was very surprising and shocking,” says Constance Dierickx, board services practice leader for RHR International, a corporate psychology management firm. “It depends, in part, on what the company was already doing. If they were doing a lot of documenting, the costs wouldn't be as high.”

Dierickx's firm and Directorship Search Group surveyed about 270 public-company directors regarding compliance costs. The survey found that for companies with annual revenue of more than \$4 billion, the average compliance cost was \$35 million, while the average cost for a mid-size public company was about \$5 million.

Those costs include employment expenditures; outside consultants to design, implement, and test new compliance systems; the cost of redeploying existing resources; and purchasing hardware and software.

Charles H. King, managing director of global board services for Korn/Ferry International, says smaller companies took more of a hit to the bottom line than larger companies. “Was this money well spent?” he asks. “For the smaller companies, if it cost them \$1.5 million, it is much more detrimental than a \$5 million or \$10 million hit to a Fortune 50 company.”

On December 16, the SEC announced it would form an advisory committee to help assess the impact of S-O (as well as other SEC corporate governance regulations) on smaller companies.

Korn/Ferry in November issued its annual worldwide board of directors study. The study concluded that S-O and other corporate governance regulations have been a significant expense. Nearly all American respondents said their companies complied with S-O at an average implementation cost of \$5.1 million. The survey also found that ongoing compliance would cost an estimated \$3.7 million per year.

“It's the law; they have to comply,” King says. “Whether you are a CEO or an audit committee chair, you could squawk all you want. I'm sure people weren't given a whole lot of choice.”

However, King says, implementation of internal controls over financial reporting will, in the end, make the audit committee's job easier because they will be on the same page as management.

Scott A. Reed, a partner with KPMG's Audit Committee Institute, agrees that ultimately this effort will make the audit committee oversight role easier.

“Audit committees are responsible for overseeing the financial reporting process of the company, and more in-depth information about the company's internal control will be an important resource,” he says. “The challenge for audit committees and management will be to integrate this effort into their ongoing processes, such as incorporating the consideration of internal controls into the audit committee's oversight approach throughout the year.”

In fact, based on the results of his focus group studies, California State at Northridge's Gray believes that corporations are gearing up for a so-called S-O section 404 II, in which some companies may incorporate internal control and compliance recommendations contained in the recent report of the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

"COSO Enterprise Risk Management–Integrated Framework" provides a comprehensive framework intended to assist companies in identifying and addressing internal control requirements and in enhancing their risk management processes.

The prospects of increased expectations of shareholders, regulators, and others for public companies makes it important that audit committees are in tune with management's efforts to continually improve a company's internal controls.

*Article written by Gary Larkin, Managing Editor, Audit Committee Insights.*

*Originally published December 29, 2004.*



## SARBANES-OXLEY

# S-O Compliance Playing Big Part in Next M&A Wave

Audit committees are finding out that the Sarbanes-Oxley Act of 2002 (S-O) has foisted upon them yet another new responsibility: greater involvement in the due diligence phase of a merger.

Although they're not required to do so, acquiring companies are expanding due diligence as a way to make sure the new, combined business will comply with S-O section 404 and other mandates, including requirements for assessing disclosure controls and procedures as well as internal controls over financial reporting. An acquiring company should assess the adequacy of the target's internal controls and whether the acquisition will affect the acquirer's internal controls.

As it oversees management's due diligence, the audit committee often should consider whether its company should take advantage of a Securities and Exchange Commission one-year reporting exemption on the target company's controls.

In the pre-closing process, management and the board of directors should decide whether or not to use the "reprieve," according to KPMG's James Aldridge, a principal in the firm's transaction services practice.

"The audit committee should be ensuring that management is undertaking an appropriate due diligence process," Aldridge says. "Then they have to ask what is management's plan for integrating the acquired company's controls after acquisition and in time for the next reporting deadline."

"Had the one-year exemption not been in place, then I think there would be fewer deals being closed later in the year," he says.

Under S-O, a company has to include an acquired business in its section 404 report and attestation for the year in which the acquisition closes. However, in June the SEC approved an exemption that permits the acquiring company to exclude the target company's business from the section 404 report and attestation if the acquiring company meets certain disclosure requirements.

The acquiring company must identify the acquired business and disclose that management excluded the acquisition from its report on internal control over financial reporting. Also, the company must indicate the significance of the acquired business to the consolidated financial statements and disclose any material change to its own internal controls over financial reporting due to the acquisition.

David Keith, senior financial analyst for Bellevue, Wash.-based M&A services provider Corum Group Ltd., doesn't see many of his firm's technology company clients exercising the exemption.

"Most buyers want to quickly assimilate the company, so we are seeing companies [assess internal control over financial reporting] as quickly as possible," Keith says. "The timing of the internal controls issue has not popped up yet."

However, a recent Corum Group report found that in 2004 technology mergers often took 12 months to close, as more people had to sign off on deals because of the S-O section 404 report and attestation.

Perhaps more telling was the report's finding that some acquiring companies want to close a transaction earlier in the year so they can have enough time to consolidate the financial reporting of the seller and meet S-O compliance requirements.

Keith has seen such due diligence take less time, particularly when the target is a public company that already complies with S-O section 404.

"Buyers are much more comfortable," he says. "Many have done several deals in the age of S-O by now. We have been advising sellers to educate themselves, and for those that are private companies, to make them as S-O compliant as they can before they enter into M&A discussions."

Saks Inc. audit committee chairman C. Warren Neel believes there is still pressure to close a deal earlier in the year. "There's some speculation that there will be more M&A action in the first, second, or third quarters of the year," Neel says.

Neel also heads up the University of Tennessee's Corporate Governance Center. "The thinking is [that] with one of these transactions, if you are going to have a 404 issue you'd want more time to fix it," he says.

Even as it is already busy overseeing its company's own financial reporting process, the audit committee also has some responsibility for oversight of due diligence.

"At a minimum, audit committees need to be involved in the process pre-closing, ensuring that when the closing occurs [management has assessed that] the financial statements will be true and accurate," says Ed Mason, partner at the law firm of Foley & Lardner in Chicago. "Sarbanes-Oxley places the audit committee [into] the process [much earlier]."

Mason, whose law firm completed a case study last year on the impact of governance reforms on mergers, has seen audit committees become quite involved in other aspects of due diligence.

"The board may use the audit committee as a special committee to see if [the merger] is valued properly," Mason says.

Neel believes that the audit committee needs to provide the necessary oversight for the parts of due diligence that the full board has assigned to it. Sometimes that may mean dealing directly with outside parties involved in a deal.

"You want to make sure you have an engaged committee—if you have a possible transaction, it gets involved with the investment bank," he says. "The committee has to ask, 'what is our process of deliberation?' and then say, 'if we are going to do a transaction, here is the process.'"

An important part of the audit committee's oversight of the due diligence process is to consider if management has fully analyzed those provisions of the actual stock purchase or asset purchase agreement that pertain to internal controls over financial reporting.

**Audit committees should be ensuring that management is undertaking appropriate due diligence when it comes to mergers and acquisitions.**

“Some of the warranties on internal controls in the agreements have gotten beefed up,” Mason says. “In many cases, the [acquiring company] may seek indemnification from the target company if internal control issues arise after closing.”

There’s a lot at stake: as of February 2, the dollar value of mergers and acquisitions for 2005 was \$132.45 billion, compared with \$85.37 billion in January 2004, according to Mergerstat.

“[The cost of compliance] now becomes part of the letter of intent negotiations—who is going to cover what costs,” Corum Group’s Keith says. “In order to get a deal done today, there must be an atmosphere of give and take, which means both parties agree to some cost sharing, with the buyer assuming a larger portion of the cost.”

In a KPMG Audit Committee Institute survey taken last fall during a series of roundtables, 34 percent of respondents said complying with S-O caused some meaningful increase in the cost of the deal. The survey seems to indicate clearly that S-O has imposed an additional cost on merger and acquisition activity.

KPMG’s Aldridge sees the S-O cost as an essential component of the overall due diligence effort. “It’s a risk awareness and mitigation exercise,” he says. “You need to consider the risks in consummating the deal. You then balance those risks against the access you get and the time and money it takes to get due diligence done.”

*Article written by Gary Larkin, Managing Editor, Audit Committee Insights.*

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**SARBANES-OXLEY**

## Whistleblower Communication Recipe Calls for a Good Filter

Now that the audit committees of most large public companies have completed the first round of section 404 compliance, there is another part of the Sarbanes-Oxley Act (S-O) that continues to attract their attention.

Section 301 of S-O requires audit committees to establish procedures for the receipt, retention, and treatment of complaints (including confidential and anonymous employee complaints) dealing with a company's accounting, internal accounting controls, or auditing matters.

The "whistleblower procedures" involve the initial processing or sorting of complaints as well as their subsequent review, investigation, and resolution. Corporate governance advisers agree that the initial screening or sorting of the complaints is critical to ensure proper handling.

For the complaints to get proper treatment they have to be initially processed by independent employees or outside consultants who can then separate them by severity and context while making sure they are delivered to the proper persons.

"The key is that the folks combing through the reports have to have independence," says Marc Katz, an attorney specializing in labor law for Jenkins & Gilchrist in Dallas. "If the company is making the first cut to see what goes to the audit committee, then you want more than one person involved. And one of the people has to have knowledge of SEC law and have a human resources background."

Most whistleblower hotlines are set up to receive all types of complaints, from human resources issues such as discrimination and sexual harassment accusations to financial reporting problems. Complaints can come via telephone, fax, e-mail, or regular mail.

But what constitutes a financial reporting complaint covered by S-O?

For a large company such as overnight package shipper FedEx, the answer to that question is spelled out in the accounting complaint policy posted on its corporate Web site. The policy defines these complaints as involving claims of accounting fraud or error, deficiencies, or noncompliance with the company's internal financial reporting controls and misrepresentation or misstatement of financial data. Its policy also covers charges of retaliation against whistleblowers.

The FedEx policy also states that while the audit committee is responsible for overseeing the whistleblower process, including any investigations, the executive vice president and general counsel are responsible for administering the procedures.

"To avoid the possibility that the only person receiving the complaint is also the subject of the complaint, all issues should be routed to at least two different persons," says Mark D. Wigder, a colleague of Katz who specializes in securities law. "This is especially important for smaller [companies] because of the smaller number of employees and the increased probability of a conflict of interest."

Wigder adds that all S-O-related complaints should be routed to the audit committee and the company's chief legal officer, human resources head, CFO, or other department head, depending on the nature of the complaint.



“It is important that for each ‘category’ of complaint there is one person who will ‘own’ the complaint and assume the primary responsibility for investigating it,” he says.

Since a larger company would likely have a higher volume of complaints than a smaller one, it needs to decide the most efficient way to process the complaints so it can act in a timely manner. It can either handle the initial processing internally, using the in-house counsel, internal audit, or an ombudsman, or it can hire an outside vendor to maintain its complaint lines.

Professor Raj Aggarwal, the Firestone chair in corporate finance at Kent State University in Ohio, likes the idea of an accounting firm that is not a company’s auditor or an outside counsel acting as the ombudsman, responsible for the initial processing of the complaint.

“I think there needs to be some kind of interface between the people who call the hotline and the audit committee,” says Aggarwal, who is an audit committee member for Ancora Funds. “I don’t think it’s effective to have the audit committee responsible for taking the calls. It is not something they know about.”

However, some smaller companies often don’t have a choice.

“Some companies have a low-tech approach,” says Scott A. Reed, a partner with KPMG’s Audit Committee Institute. “I’ve heard of a few instances where they give the phone number of the audit committee chair to all employees.”

Regardless of who initially receives or processes the complaints, the audit committee should establish a policy regarding which types of complaints it should specifically review.

According to a survey taken in January at The Annual Audit Committee Issues Conference, 52 percent of participants said the audit committee received every unfiltered whistleblower communication. Many advisers recommend that the audit committee at least receive all whistleblower communications involving accounting, auditing, or internal control issues, as well as communications involving criminal conduct or officer misconduct.

But only a small percentage of all complaints that come in on these hotlines are typically related to financial reporting, according to Reed.

Stephen Tisdell, president of whistleblower hotline consulting firm, The Compliance Partners in Franklin, Tenn., says on average only 1 percent of the employee base will submit a complaint to a whistleblower hotline. Of that, only about 1 percent will involve financial reporting problems or fraud, Tisdell says.

His company, which is two years old, was created to support audit committees and corporate management in complying with the whistleblower procedure section of S-O. Other such companies include SilentWhistle Corp., ShareHolder.com, SECTips.com, and Confidential Corporate Solutions International LLC.

“Generally, 95 percent of complaints are phone calls, 4 percent are Web/e-mail, and the rest are from U.S. mail,” Tisdell says. All the information from the calls and mail are entered into a database along with a reference number. Compliance Partners uses a call center as well as software to collect and filter the complaints. It also uses four different scripts when receiving

complaints, including one specifically for Health Insurance Portability and Accountability Act (HIPAA) violations and another for general corporate fraud.

Compliance Partners sends a report to the audit committee, telling how the complaint was received, the name of the complainant, whether or not management has been informed, how many individuals may be involved, and a description of the action. The report also categorizes the claim as “potentially serious” or “operational.”

Compliance Partners issues a form letter on behalf of the company or the audit committee to the whistleblower to begin a dialogue. Then it is up to the audit committee to determine if an investigation is worth pursuing.

At FedEx, its alert line service provider, ShareHolder.com, its audit committee, or its general counsel will contact each employee or contractor who files a complaint to inform him or her of the results of the investigation and of any corrective action that was taken. This is part of the company’s accounting complaint policy, which is posted on its Web site.

It is at this point that audit committees may be vulnerable to lawsuits and possible SEC violations, according to attorney Stephen Kohn, chairman of the board of the National Whistleblowers Center.

“The risk the company has is if the audit committee mismanages the [complaint] information, and it can turn into an SEC violation,” says Kohn, who is a partner with Kohn, Kohn & Colapinto in Washington, D.C.

In such a case, a company could have legal exposure if the company didn’t respond properly to the whistleblower complaint, and that person goes to the SEC, Kohn says.

Audit committees also have to consider possible independence concerns with third-party vendors.

“There have been cases where a third-party sub-contractor that was afraid of losing the [whistleblower] contract would have more of an interest in pleasing the company than making it look bad,” Kohn says. He also points out that it is up to the audit committee to “monitor the monitors.”

Kent State’s Aggarwal, who is also a trustee for Financial Executives Research Foundation, says that FERF is considering a study into effective whistleblower programs. Such a study would review companies’ experiences with internal and external administration of the whistleblower program as well as best practices.

“I think somebody needs to provide guidance on it [whistleblower program],” he says. He also thinks more companies will focus on the effectiveness of these programs now that they have gone through the first round of internal control disclosure compliance under S-O.

Ultimately, the goal of the S-O whistleblower provisions is to encourage whistleblowers to come forward by providing them a channel to notify company representatives of possible misconduct, and to protect them from retaliation by the company.

Lawmakers saw the benefit of people coming forward to report on possible frauds. They learned from the Enron scandal, where a whistleblower’s testimony brought to light the accounting fraud case.

**Whistleblower hotlines are designed to handle issues as varied as sexual harassment and standard financial reporting problems. But what about a financial reporting complaint covered by S-O?**

“An effective whistleblower communications process can be a vehicle for bringing to the attention of the audit committee possible ‘red flags’ that might not have been identified through the company’s other processes,” says KPMG’s Reed. But, he adds, “the trust that potential whistleblowers have in the process, and ultimately its effectiveness, is very much reliant on active oversight by the audit committee.”

*Article written by Gary Larkin, Managing Editor, Audit Committee Insights.*

*Originally published June 15, 2005.*

**FINANCIAL REPORTING**

## Principally Speaking, Standards Need Rules

When the Financial Accounting Standards Board's (FASB's) exposure draft on its statement for business combinations comes out later this year, it will reflect a new way of thinking for audit committees that oversee corporate financial statements.

The exposure draft also helps point the way toward the gradual process of principles-based, or objectives, accounting. The exposure draft is expected to mark a change from a standard-setting process that has provided specific guidance for more than 20 years, having evolved into a rules-based system.

Many in the financial reporting community say that a principles-based system might lead to a lack of consensus on accounting, and the possibility of shareholder lawsuits. Some audit committee members have expressed concern they'll need more time to do their jobs under a principles-based system.

In addition, many believe that regulators—including the Securities and Exchange Commission (SEC)—have yet to fully appreciate the fact that management, auditors, and audit committees will have to make more judgment calls than in the past.

What's more, the standards are evolving against the backdrop of more SEC regulations borne out of the corporate accounting scandals of the past several years.

In a July 2003 study, the SEC weighed in on the adoption of a principles-based accounting system in the United States, as called for under the Sarbanes-Oxley Act of 2002. The SEC study referred to the use of "bright lines," or specific rules, and exceptions as a "game" that becomes more complex as standard setters attempt to fill loopholes and "financial engineers" find ways around them.

"I'm amused that people say we have a checkbox mentality," says C.H. Moore Jr. of Dallas, who serves on three audit committees, including chairman for Perot Systems and Kronos Worldwide. "But when you get government regulations like we have, you have to comply with them.

"With the SEC wielding a hammer in its hand, it could come down at any time," says Moore, who also serves on NL Industries audit committee. "The SEC has to let the judgment of the audit committee stand, if it's within reason."

One accounting professor who was an academic fellow with the SEC in 2001 believes the shift to more subjective judgments from bright lines will be one of the greatest challenges for audit committee members.

"It will involve a lot more work," says Vivek Mande, director of Cal State Fullerton's Center for Corporate Reporting and Governance. "There will be certain areas where it won't be clear which direction to go.

"[Audit committees] will have to know to ask the right questions. They need to understand the objective. And they will need a lot more time, training and there will be a lot more documentation."



**Many fear that a principles-based system might lead to a lack of consensus on accounting—and a lot more work for audit committees.**

Mande is most worried about the audit committees of smaller firms. “In Orange County [Calif.], there are a lot of small, bustling firms,” he says. “They are having problems getting independent committee members with financial expertise. On average, it’s costing them \$90,000 per member.”

Audit committees at smaller companies—facing higher costs and with fewer resources than large firms—may have difficulty overseeing the complex judgments in a principles-based system, Mande says.

But many accounting observers agree FASB’s change in its guidance-setting process will be gradual and include implementation guidance, although not like the bright lines that some corporations might have used to reach desired results in their financial reporting.

Mark M. Bielstein, an audit partner in KPMG’s Department of Professional Practice, believes judgment will be the operative word in a principles-based system, especially when you consider that such a system may, in many cases, be absent exceptions or bright lines.

“It may be more challenging for auditors and audit committees to make and evaluate those subjective judgments,” he adds.

But just when will corporations start seeing full-scale changes in the accounting system? It may be a long while.

“It’s very uncertain [that] you’re going to see strictly principles-based standards,” says Joel Seligman, the dean of Washington University’s School of Law in St. Louis. “In its 2003 study on objectives-based accounting, the SEC was somewhat tepid. There isn’t even a proposal on the table yet.”

Seligman, who also sits on the audit committee of NASD, says that when the dust settles, there will be a hybrid standard-setting process.

Katherine Schipper, a FASB member since 2001, has written extensively on principles-based accounting standards. In a March 2003 *Accounting Horizons* commentary, Schipper wrote that the requirement of professional judgment under principles-based accounting might conflict with the need for rules or guidance that preparers will seek.

She wrote: “If the Sarbanes-Oxley Act opens the door to ever more detailed legal prescriptions for the behavior of officers and directors, I predict that preparers of financial reports and the audit committees charged with oversight of the process will seek ever more detailed guidance as to precisely what is expected in terms of their role in financial reporting. That is, they will seek rules.”

FASB has had an ongoing dialogue with the SEC about how to establish such a system since October 2002 when FASB wrote its “Principles-Based Approach to U.S. Standard Setting” proposal. FASB received 135 comment letters regarding that proposal with many in favor, but some questioned its timing. Those in favor included CFOs, the California Public Education Retirement System, and the American Institute of CPAs (the latter, with some caveats). Those voicing concern included external auditors.

In its response last month to the 2003 SEC study, FASB agreed with the finding that although its existing standards are based on principles, they could be written more clearly. The SEC, which submitted that study to the Committee on Banking, Housing, and Urban Affairs of the Senate and Committee on Financial Services of the House of Representatives, also agreed, stating that some kind of written guidance would be needed.

The change to a principles-based system is part of an overall simplification and codification project that is taking place as FASB also works on converging its standard-setting process with the International Accounting Standards Board (IASB), which is developing international financial reporting standards.

“There’s no timetable, per se,” says Kim Petrone, FASB director of planning, development, and support activities. “It will be a gradual change in how we develop standards.”

She pointed out that the exposure draft on the board’s statement on business combinations, due in the fourth quarter, will be the first to reflect stricter principles-based accounting as well as the use of the IASB’s black letter/gray letter style. That’s where bold print letters are used to emphasize basic requirements of a standard and gray lettering is used for explanatory text.

*Article written by Gary Larkin, Managing Editor, Audit Committee Insights.*

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## FINANCIAL REPORTING

# XBRL: The New Acronym in the Financial Oversight Lexicon

Financial reporting is catching up to Web-based technology in the form of extensible business reporting language (XBRL).

“[XBRL] would be great for benchmarking,” says Robert R. McMaster, the audit committee chairman of Warrendale, Pa.-based American Eagle Outfitters. “But it depends on how widely it is accepted.

“Trade organizations [now] make such [financial reporting] information available,” he says. “The standardization of the same information validates the comparisons.”

The software standard, which a CPA created in 1998, allows for “tagging” information so that once it is entered into a computer system it can be made available for multiple applications without being reentered.

“It’s the ‘do it once, report it many [times]’ standard,” says Glen Gray, an accounting and information systems professor at Cal State at Northridge.

The XBRL International Consortium of 250 organizations, which includes the Big Four accounting firms, electronic publishers, computer technology firms, and standard-setting groups, has spent the past few years developing the tags and corresponding definitions.

According to David vun Kannon, a senior manager with KPMG’s Audit & Advisory Services Center, audit committees can benefit from XBRL-enhanced computer tools to benchmark a company’s financials. Audit committees can use XBRL to help oversee the external audit plan and process, monitor internal control over financial reporting and auditor independence, and oversee internal audit.

XBRL permits multiple software applications to automatically extract information and allows for automated comparison of financial and other business information for benchmarking, tasks that are usually done manually.

“One of the things we’re showing in our academic research collaborations is that XBRL can be used to help document Sarbanes-Oxley [internal control over financial reporting],” KPMG’s vun Kannon says.

“Companies have been documenting controls and processes for the first year of Sarbanes-Oxley [S-O] section 404 compliance, but many of the tools they bought to help with that process didn’t have good integration with their financial reporting systems,” he says.

XBRL can also be used to help focus the audit effort, vun Kannon says. “You can use it for workflow and process for the auditors,” he says.

But more importantly, audit committees will find that the way they have completed their oversight of their companies’ internal control over financial reporting and benchmarking of competitors will change drastically. For starters, the Securities and Exchange Commission and the Federal Deposit Insurance Corporation (FDIC) have already introduced the technology to their filing processes.

And on May 25, the Public Company Accounting Oversight Board (PCAOB) issued a guide to external auditors who are attesting engagements that involve XBRL-enhanced data.

“Audit committees haven’t been well supported by technology in the past,” says vun Kannon. “They have been used to someone faxing them a document and they say yes or no.”

Some audit committee members may want access to a database, vun Kannon says. And that requires a lot of technology support.

Considering that many audit committee members may not have heard of XBRL, it’s safe to say there is a learning curve involved. The key is for those directors to access computer applications that use XBRL.

American Eagle audit committee member McMaster, who retired in January as CEO of communications firm ASP Westward, sees the tagging standard working well with the so-called “computerized dashboard,” an interface that presents information in an easy-to-read format.

“This [XBRL] may expand the dashboard concept and make it more robust,” McMaster says. “XBRL isn’t inventing performance monitoring concepts. It’s making it more readily available.”

Just like the World Wide Web needs browser applications to work, XBRL needs applications that can make use of it, and software and online publishing companies are developing those applications.

“We’re seeing Edgar Online and others developing applications,” vun Kannon says, though the applications are not specifically designed for audit committees.

That’s where software companies step in to build customized “middleware” that can tweak an application for a specific use.

Edgar Online, a founding member of the XBRL consortium, plans to market a dashboard designed for audit committee members, according to Greg D. Adams, Edgar Online COO and CFO.

“We’re going to sell the audit committees directly or the CFO offices,” Adams says. Edgar Online has worked with business intelligence software firms Theoris and Business Objects to develop the XBRL-enhanced dashboards.

“For \$20,000, a CFO can buy three [licenses] for the dashboard,” Adams says. “The CFO can give audit committee members another way to do independent verification of financial data.”

A hyperlink to Edgar Online’s Web-based database of XBRL-tagged financial data allows Excel® spreadsheet users to build internal reports comparing previous quarters or years. And XBRL-enhanced dashboards can build financial reports that compare different companies.

Denver-based Rivet Software has also developed XBRL-tagged applications for Microsoft’s Excel and Word® programs. The company’s Dragon Tag software can customize XBRL applications.

According to a KPMG 2004 white paper, “Improving Regulatory Reporting: Realizing the Benefits of XBRL,” the standard can be viewed as a system of bar codes for financial statements. The paper notes that XBRL-coded information can be retrieved because the context of the data is communicated along with the content.

**XBRL promises major changes in how audit committees complete oversight of internal control over financial reporting and benchmarking of competitors.**

In order for this standard to work, the XBRL International Consortium had to agree on the tags and their taxonomies or definitions.

“We said, ‘Let’s all agree on internal tags,’” says Cal State’s Gray, a founding member of the consortium. “For banks there would be a set of tags. For mutual funds, there would be a different set of tags.”

The taxonomy defines accounting and financial data items for each industry. For example, the FDIC has its own taxonomy; it is preparing to mandate the use of XBRL call reports, Gray says.

To date, the FDIC is the only regulator that has required the tagging standard. It is mandating that, by October, all of the approximately 9,000 banks that report to the agency file XBRL-based call reports. The FDIC is trying to cut banks’ reporting time from 45 to 30 days.

The technology allows the FDIC to embed its validation rules in the XBRL requirements that are sent to banks. That will allow banks to evaluate their own data before submitting it to the regulator.

The Securities and Exchange Commission last month started a voluntary program of receiving electronic XBRL-based financial statements from public companies on its EDGAR system. The SEC wants companies to assess XBRL’s effectiveness to see if the standard can streamline financial reporting and reduce the risk of errors, Don Nicolaisen, the SEC’s chief accountant said in a prepared statement.

Generally, companies appear to be taking a cautious approach to XBRL. As of April 26, only two companies had participated in the SEC program, Peter Derby, the agency’s managing executive for operations and management, said in a speech at the XBRL International Conference in Boston.

If more companies realized that XBRL might be able to help lower fraud risk, they’d be more likely to embrace the standard.

“The real benefit is that everything in the company [financial statements and business reports] will be standardized,” Gray says. “Everybody up and down the economic chain can do analysis.”

If such technology had existed in the 1990s, Gray believes that some of the worst corporate fraud cases might have been discovered earlier—or even prevented.

“When you look at some of the worst audit failures, if a company had such a tool for analysis, then somebody might have helped detect such fraud,” he says.

*Article written by Gary Larkin, Managing Editor, Audit Committee Insights.*

*Originally published June 1, 2005.*

**REGULATIONS**

## Beware of the Fine Print in Those Forward-Looking Statements

It could be the fact that a patent on a software company's best-selling program is due to expire in 18 months. Or that a biotech company is in talks to merge by the next quarter. Or that a defense manufacturer may lose key government contracts at any time due to federal budget constraints.

One thing these scenarios have in common is that they involve forward-looking statements. And the audit committee must oversee that, at the time disclosure is made, management knows it is accurate, while ensuring that management reviews and updates cautionary statements in such releases each quarter.

Under the Private Securities Litigation Reform Act (PSLRA) of 1995, forward-looking statements are those that contain a projection of earnings or other financial information, a statement of the plans and objectives for future operations, or a statement of future economic performance. These forward-looking statements are often included in management's discussion and analysis (MD&A) of the company's financial condition.

MD&A is addressed by Item 303 of SEC Regulation S-K, which dictates what management needs to discuss with its board, and what to disclose to investors. Specifically, it spells out what needs to be disclosed relating to a company's liquidity, capital resources, and results of operations.

"Audit committee members should understand [Item] 303 and the safe harbor requirements," Teresa E. Iannaconi, partner in charge of KPMG's SEC and Practice Advisory Group, says about the SEC regulation. "The SEC wants you to provide as much information as possible to the investor but forward-looking information must be considered carefully to make sure it is fully compliant with the requirements of the securities laws and the safe harbor legislation."

Item 303 requires, among other things, that the MD&A describe any known trends or uncertainties that have had, or that the registrant reasonably expects will have, a material favorable or unfavorable impact on net sales or revenue or income from continuing operations. This requires disclosure of information that is forward looking. By its nature, forward-looking information entails some risk, since it addresses events in the future.

"For example, suppose I am a software company and I have a known material trend," Iannaconi says. "My best-selling product is subject to a patent or licensing protection. That patent is due to expire in 18 months. That means other software companies could produce versions of the software that will result in declines in our revenue. This is a situation that involves uncertainty that may have a material impact on future sales and income."

According to the SEC's 2003 interpretive guidance on the regulation, management has to provide an analysis of the events as they pertain to the financial statement. The challenge is to provide information that fully satisfies Item 303 of Regulation S-K and complies with the safe harbor requirements.

As audit committee members consider financial disclosures, they should also be looking at accompanying "cautionary statements."



**One way for audit committee members to help avoid shareholder actions is telling management to update cautionary statements regularly.**

“How can you tell what is a meaningful cautionary statement?” asks Bruce A. Ericson, a partner with San Francisco–based Pillsbury Winthrop LLP. “Make sure you are covering the risk factors you are facing, which are specific to your company and industry. But it can’t be boilerplate.”

Ericson, the national head of his firm’s securities litigation team who has written many cautionary statements, points out that one way for audit committee members to avoid shareholder actions is to tell management to update cautionary statements on a regular basis.

“It’s good to update the cautionary statements each quarter in the 10-Q,” he says. “Make them fresh. Just don’t hit the print button each time a financial statement is due out.”

The key language in almost all cautionary statements is “these forward-looking statements speak only as of the date of this press release.”

While the law doesn’t specify a time frame, it does allow for the safe harbor based on a company’s good faith projections at the time of the projection. This was included in the law because the spate of securities lawsuits in the mid-1990s tried to hold companies accountable to all disclosures as of the time of the litigation, rather than as of the time the disclosures were made.

A 1995 congressional conference committee report on PSLRA stated that cautionary statements must not be boilerplate warnings but instead “must convey substantive information about factors that realistically could cause results to differ materially from those projected in the forward-looking statement.”

The PSLRA provides two levels of protection for companies, according to Ericson, the first of which is straightforward: “There is absolute immunity from shareholder lawsuits if a forward-looking statement comes with meaningful cautionary language,” he says.

As for the second level of protection, when there is no cautionary language accompanying a forward-looking statement, a plaintiff has to prove “deliberate recklessness” on the part of the company. “They [have] to prove the person knew it was false,” Ericson says.

In one case, shareholders sued a medical equipment company, challenging whether statements made about certain risk factors were indeed forward-looking and therefore would be granted safe harbor.

After a trial court ruled in favor of the company, an appeals court reversed the decision. The company hopes to bring the case to the U.S. Supreme Court, Ericson says.

“It would be the first case the Supreme Court would take under PSLRA,” he says.

Nell Minow, editor of *The Corporate Library* and shareholder activist, believes that while attorneys need to review company disclosures, management shouldn’t allow them to become too involved.

“You want to be advised by the lawyer,” Minow says, “but you don’t want comments coming from the company that are massaged by the lawyers. If it gets homogenized into nothingness, then it’s not doing anyone any good.”

When you add the fact that most public companies face accelerated reporting deadlines (60 days from 75 for 10-Ks and 35 days from 40 for 10-Qs) under SEC rules, the time frame for reviewing a company's disclosures becomes paramount.

"We are generally provided with press releases and SEC filings as far in advance as possible, generally three days to a week [ahead]," says William Donovan, audit committee chairman of Grey Wolf Inc., a provider of contract land drilling services. "Given the accelerated reporting deadlines, it's a little bit more challenging."

The expanded disclosure requirements place additional burdens on audit committees, according to Scott A. Reed, a partner with KPMG's Audit Committee Institute.

"Given the increased disclosure requirements and the shortened disclosure time frames, the audit committee and management must have a process in place that will ensure that the audit committee has sufficient time to review and discuss any disclosures before their release," Reed says.

On his audit committee, Donovan has seen a great deal of discussion on the language of forward-looking statements in releases.

"Some audit committee members have been in the position of CEO or writing press releases," Donovan says. "It's not unusual that a member of the committee tries to change something since there's a fairly extensive review process."

Donovan, president and CEO of Zeeland, Mich.-based Total Logistics Inc., a national provider of integrated logistic services, has a policy for reviewing important documents such as financials. "All information released to shareholders and government should be reviewed by the audit committee at a minimum," he says.

However, Donovan says his company's 10-Q and 10-K SEC filings should also go before the whole board of directors.

*Article written by Gary Larkin, Managing Editor, Audit Committee Insights.*

*Originally published January 26, 2005.*



## REGULATIONS

# Audit Committees Take Aim at Fraud

When it comes to malfeasance, audit committees face a Herculean task in this post-Enron world: assessing the risk of management overriding internal controls, which can lead to financial statement fraud.

An average of 25 months passes between financial statement fraud being perpetrated and its discovery, according to “Report to the Nation on Occupational Fraud and Abuse,” a report by the Association of Certified Fraud Examiners. By the time financial reporting fraud has been discovered, the damage has already been done to the company’s reputation—as well as its coffers.

The stakes could not be higher. Financial reporting fraud has more than doubled since 1998, to 7 percent of frauds committed, according to the KPMG *Forensic Fraud Survey 2003*. And consider that while financial reporting fraud makes up a small percentage of total corporate crime, it represents a large majority of total costs from malfeasance. The average annual cost was more than \$250 million for companies suffering from fraudulent financial reporting, according to the KPMG survey.

But for audit committees, making sure that management does not override internal financial controls seems nearly impossible. Other than a good whistleblower system, how can audit committees help stem financial reporting fraud?

To begin, they can improve communications with key parties involved in the financial reporting process, and come to the realization that the risk of fraud exists at every organization.

That’s part of the message of “Management Override of Internal Controls: The Achilles’ Heel of Fraud Prevention,” a document from the Antifraud Programs and Controls Task Force of the American Institute of Certified Public Accountants.

“Our [report] outlines specific steps audit committees can take to address the risk of management overriding established internal safeguards,” says John Morrow, AICPA vice president of business and industry. “Had audit committees taken these steps, many financial frauds may have been prevented.”

The AICPA task force defines management override of internal controls in several ways. It can be misstating the nature of transactions, recording fictitious transactions, changing the timing of recognition of real transactions, abusing reserves to manipulate results, and altering records related to such transactions.

These types of management overrides allegedly occurred at Enron, WorldCom, and HealthSouth.

The consensus among audit committee members, academics, and auditors who collaborated on the AICPA document is that audit committees must build a strong internal communication network through which the possibility of management override of internal controls is discussed.

“I would put the audit committee into executive session and have them ask, ‘where are we vulnerable, where can management be overriding internal controls, where are they concealing it?’” says Mark Beasley, an accounting professor at North Carolina State University who sat on the task force.

“I would bring the external auditor and internal auditor into separate executive sessions,” he says.

Beasley goes as far as calling for representatives from human resources and general counsel to attend executive sessions. “If we are seeing things on the HR side where people are leaving the company because they are uncomfortable, that may be a sign something’s wrong,” Beasley says.

Via an extensive information network that includes external and internal auditors, the compensation committee, and key employees, an audit committee improves the likelihood that it will discover management override of internal controls.

“The audit committee has to constantly assess the integrity of management,” says Dan L. Goldwasser, an audit committee member for New York–based pharmaceutical company Forest Laboratories. “There are things to look for. The easiest way is to keep tabs on management’s perks.”

Goldwasser, who served on the task force and is a partner with the law firm of Vedder, Price, Kaufman & Kammholz in Chicago, believes the audit committee should be responsible for guiding internal and external auditors in reducing the risk of management override of internal controls.

Les Hand, a partner with KPMG’s forensics practice, advised the AICPA task force. He sees the audit committee as vital to stopping financial reporting fraud.

“The audit committee plays an important role in the detection process by helping ensure the company’s fraud risk plan is in place and that meetings are held with key gatekeepers,” Hand says.

Hand cites an idea that one of his clients decided to try as a fraud prevention measure. An audit committee Hand has worked with brainstormed with management, internal audit, and the external auditor to identify key strategic risks. Then, each leader of the company’s business units made a presentation, quantifying major financial reporting fraud risks.

“The business unit leader has to talk about what controls there are,” he adds. “The audit committee says, ‘tell me how you monitor that.’”

Dana Hermanson, an accounting professor at Kennesaw State University in Kennesaw, Ga., suggests that middle and lower management should be a part of any information network. Hermanson has found that CEOs or CFOs were implicated in more than 80 percent of financial reporting fraud from 1987 to 1997.

“In an accounting fraud setting, boards [that interact] only with the CEO and CFO may just be talking to the main perpetrators of the fraud,” he says. “Because so many accounting frauds are orchestrated by top executives, boards and audit committees need access to personnel beyond the small group of top executives.”

In addition to an information network and whistleblower program, the AICPA task force recommends that audit committees maintain skepticism toward management and strengthen their understanding of the business. They also should brainstorm to identify fraud risks and use the code of conduct to assess financial reporting culture.

**According to a KPMG survey, the average annual cost for companies suffering from fraudulent financial reporting was more than \$250 million.**

“The idea is they have to be skeptical,” says Michael P. Glynn, technical manager of Audit and Attest Standards for the AICPA. “They can’t take the management’s word on everything. The audit committee has to be aware that management isn’t going to come up and say, ‘We’re overriding controls.’”

Glynn explains that financial reporting fraud often isn’t done maliciously, but instead can happen when management is about to miss an earnings target.

Energy trader Enron and telecommunications company WorldCom (now MCI) are two of the most prominent examples of alleged financial reporting fraud. Enron overstated its earnings by more than \$580 million from 1997 to 2001, and then in 2001’s third quarter posted a \$638 million loss.

An SEC investigation soon after discovered that Enron’s infamous special-purpose entities, or off-balance-sheet partnerships, were allegedly used to defraud investors. In the past year, fraud indictments were handed out to former Chair and CEO Kenneth Lay, former COO Jeffrey Skilling, former chief accounting officer Richard Causey, and several other executives.

WorldCom’s alleged fraud was not as complex, but was historic in its size—\$11 billion. The telecommunications giant’s former CEO, Bernard J. Ebbers, and former CFO, Scott Sullivan, have been charged with fraud, conspiracy, and making false regulatory filings. As part of a plea-bargain agreement, Sullivan pleaded guilty in exchange for testifying for the federal government against Ebbers.

They have been accused of a revenue recognition scheme from September 2000 to July 2002 that greatly inflated company earnings to meet Wall Street targets.

Enron is a small shell of its former self; MCI recently announced that Verizon was buying the former telecom giant.

“In the case of WorldCom, revenue was coming in too low,” Glynn says. “There was a quarter where the company was missing its earnings target. They decided to take some expenses off the financial statement. So then the expenses were smaller and the net revenue was higher.”

A key to detecting any type of financial reporting fraud is to look for red flags, industry observers say. These red flags may include low employee morale, employee turnover in the accounting department, pressure to meet unrealistic financial targets, and infighting among top management.

“The audit committee should encourage the right tone at the top, and be sure that any potential ‘red flags’ are explored and resolved to the audit committee’s satisfaction,” says Scott A. Reed, a partner with KPMG’s Audit Committee Institute.

Those red flags serve as leads for forensics professionals, who can follow an electronic trail of company and personal e-mail to track alleged wrongdoers.

“In all the years I’ve been doing this,” says KPMG’s Hand, “I can say about 90 percent of the [fraud] cases have turned on electronic data. E-mail traffic is what gets people.”

*Article written by Gary Larkin, Managing Editor, Audit Committee Insights.*

*Originally published February 23, 2005.*

## REGULATIONS

## Forensic Accounting Pieces Together Fraud

As more financial reporting frauds become public knowledge, audit committees are getting a crash course in forensic accounting.

“The forensic process is done at a very detailed level,” says Les Hand, a partner with KPMG’s forensics practice. “You have to understand the allegations. You have to figure out who are the people who were participating. You also have to go one level above and one level below those people most likely to be the focal point of the investigation.”

Audit committees can act as intermediaries in overseeing forensic teams and corporate management in investigating fraud. The audit committee hires legal, accounting, and other services related to oversight of an investigation. This responsibility goes hand-in-hand with the committee’s duty to oversee risk management and internal controls over financial reporting.

Forensic accounting involves investigating an alleged crime. The forensic accountants interpret evidence so that it can be delivered in plain English to the audit committee and others. The facts discovered in an investigation help determine the economic effect of fraud, which often leads to an earnings restatement.

But before any forensic accounting takes place, the audit committee must determine if such an investigation is warranted. During the audit committee’s review of financial results, members should pay attention to potential fraud risk indicators, according to “Fraud Risk Considerations,” a publication prepared by KPMG’s Audit Committee Institute following its spring 2004 roundtables.

“Examples of such conditions might include sales and income decreasing while accounts payable and receivable rise, a line of credit that is ‘maxed out’ for long periods of time, or loans that are continuously rolled over,” according to the KPMG publication.

Hand spells out some steps he takes when looking at possible fraud.

“We want to understand the [internal control] process that is in place at the company,” he says. “We want to know what breakdowns occurred at this company.”

Former U.S. Secretary of Commerce Barbara Franklin recalls how networking played a part in choosing an outside counsel when she served on an audit committee that oversaw a fraud investigation.

“We asked the general counsel in the company where he would go to seek such counsel,” says Franklin, who chairs insurer Aetna Inc.’s audit committee. “Then we set up a process where we had three candidates who were all reputable.”

The whole audit committee interviewed the candidates, taking into account their various backgrounds and fee structures, Franklin says.

When it establishes expectations regarding antifraud programs, an audit committee should seek input from legal counsel as well as internal and external auditors, according to “Fraud Risk Considerations.”

The publication also calls for the audit committee to encourage management to implement a designated antifraud team, use fraud-tracking and monitoring software, and have a detailed fraud response plan in place.



**Audit committees play a vital role in helping an investigation that involves forensic accounting.**

As audit committees oversee a fraud investigation, they can tap resources such as the “Internal Control Framework” of the Committee of Sponsoring Organizations (COSO) of the Treadway Commission.

Audit committees also need to be cognizant of what a forensics accounting or investigative team will be examining. A key to any forensics process is electronic data, including accounting records, journal entries, and e-mail.

“The devil is in the details,” Hand says. “A clear majority of all bad accounting is uncovered using data mining techniques and software.”

Computer forensics firms, which work on tracking down electronic information, are also tools in a fraud investigation.

Warren Kruse Jr., managing partner of Computer Forensic Services in Eatontown, N.J., notes an SEC case in which outside counsel working on behalf of an audit committee asked Krause’s company to preserve personal computers that would be helpful to the investigation.

“We asked if there were any file servers, e-mail servers, etc., that would also need to be preserved, and the answer was no, ‘everything was stored on the PCs,’” Kruse says. The servers containing the requested files were in a location that was several hours away.

Kruse says that it’s important that a forensic computer firm be provided with specific information, such as file names. Otherwise, vital files could remain hidden on a computer network.

“Once we have all the data we need, we can retrieve deleted files and e-mail,” he says. “We have assisted in password cracking on spreadsheets containing financial data, and have retrieved numerous copies of financial program files when more than one set of books existed.”

A computer forensics company is one of the many resources at an audit committee’s disposal. They need several, as the types of frauds can be numerous.

One more common revenue recognition fraud is the “round-trip transaction,” in which a company sells a product to a reseller and then buys it back for a higher price. As a result, the company inflates revenue with false sales.

Another common scheme is “cookie jar accounting” or income smoothing. Unscrupulous managers will take a reserve to reduce profits in good years, and then use that reserve to smooth out profits in bad years.

One recent round-trip transaction involved the business integration software firm webMethods Inc. of Fairfax, Va. The company’s audit committee oversaw an independent investigation into a license transaction fraud at webMethod’s Japanese subsidiary. Following the probe, the company restated earnings for fiscal year 2004, quarterly earnings for 2004, and the first quarter of fiscal 2005, according to Securities and Exchange Commission filings.

The fraudulent activity led the subsidiary, webMethods K.K., to overstate its license revenue in fiscal 2004 by about \$4.5 million to \$5 million, overstate services revenue by about \$450,000 to \$600,000, and understate expenses by about \$450,000 to \$550,000, according to an SEC filing.

“Our response in this matter shows that webMethods takes concerns and allegations regarding its integrity and business practices very seriously,” David Mitchell, company president and CEO, said in a prepared statement. “Once alerted to a potential issue, we promptly notified our audit committee, which immediately engaged outside experts to conduct a thorough and complete investigation.”

In the same statement, Mitchell said the subsidiary’s management was replaced and that internal controls throughout the company were being reviewed.

A whistleblower at webMethods K.K. prompted the investigation. As part of the investigation, the audit committee hired independent counsel, which then hired forensic accountants. The company notified the SEC of the alleged fraud and the investigation on January 28.

The audit committee concluded that a number of workers there took part in such activities as improper licensing transactions and misrepresenting those transactions to management. It also discovered those transactions led some employees to make unauthorized loans. The committee’s forensics accountants found that employees created false documents to support the transactions and concealed their actions from management.

Such cases highlight the need for companies to implement a detailed fraud response plan.

Ultimately, a critical part of the success of a financial reporting fraud investigation comes down to the judgment of the audit committee—and how engaged it is.

“After all,” says former commerce secretary Franklin, “the audit committee is the guardian of a company’s internal controls and reputation at the board level.”

*Article written by Gary Larkin, Managing Editor, Audit Committee Insights.*

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## PERSONNEL

# Audit Committee Financial Literacy: It's Not Just for the Experts Anymore

Just what do audit committee members need to know about “financial literacy,” “financial expertise,” and the “audit committee financial expert”?

Between the Sarbanes-Oxley Act of 2002 (S-O) and equity markets’ listing standards, there’s plenty.

The major U.S. stock exchanges have required for many years that audit committees be made up of at least three independent, financially literate directors, one of whom needs to have financial expertise.

Since the passage of S-O, boards and audit committees have been considering the makeup of the audit committee, particularly how it relates to independence requirements and the new definition of the audit committee financial expert (ACFE) that the SEC issued in January 2003.

“The challenge for companies is not only to identify an individual to serve as the audit committee financial expert but also to convince that individual to accept this designation with the increased expectations and possible exposure it may entail,” says Scott A. Reed, a partner with KPMG’s Audit Committee Institute (ACI).

According to the final SEC rule, companies lacking an ACFE must disclose the fact and the reasons why. The board of directors is responsible for deciding whether its audit committee meets the ACFE requirement.

Among other things, the SEC defines an ACFE as an audit committee member who has an understanding of the Generally Accepted Accounting Principles (GAAP) and financial statements. Generally, the ACFE should also have the ability to apply such principles with regard to accounting for estimates, accruals, and reserves; have experience preparing, auditing, analyzing, or evaluating financial statements; and have an understanding of audit committee functions.

While the definitions of financial literacy, financial expertise, and ACFE vary, any audit committee that lacks the aptitude to question a public company’s financials might be in trouble.

“ACFEs are cognizant of other audit committee members’ contributions—they don’t want to be making decisions unilaterally—and they want to be sure all members are up to speed on the financial reporting and other issues the company may face,” Reed says.

There is more at stake than simply good corporate governance.

“Educating oneself on the accounting issues for your company is simply good [business],” says Lawrence J. Abbott, a professor of accounting at the University of Memphis. “This is not to say that someone [needs to] obtain a CPA designation.”

Both the New York Stock Exchange (NYSE) and NASDAQ encourage directors to obtain additional education; NYSE requires that listed companies establish and disclose corporate governance guidelines that address director orientation and continuing education.

In addition, groups that evaluate corporate governance often track directors’ continuing education. The result of all this activity is a proliferation of external education programs available to directors and audit committee members.

External education programs available to directors and committee members include those provided by the National Association of Corporate Directors, The Conference Board, universities, and other providers.

“Right now there is a cottage industry in the area of governance,” says C. Warren Neel, executive director of the University of Tennessee’s Corporate Governance Center. “Firms are choosing people who understand how audit committees work.”

What’s more, audit committee members are asking for tailored, in-house programs as a convenient, fast way to come up to speed on critical issues. These customized “in-boardroom” sessions are led by management, internal audit, the company’s counsel, auditors, and others.

Mark Terrell, executive director at KPMG’s Audit Committee Institute, says that when it comes to education, the boardroom can sometimes be even better than the classroom.

“With the whole audit committee there and all the participants involved, it can be a very powerful educational session,” Terrell says, referring to the inclusion of management and internal and external auditors in such a meeting. “It gives the audit committee the opportunity to delve into important topics specific to that company.”

There are other benefits to such sessions, Terrell says. “One of the greatest benefits of these in-boardroom sessions is that audit committee members have a chance to discuss and identify additional areas they would like to explore in the future.”

A survey of participants at ACI’s Audit Committee Roundtables held in May and June found that 34 percent expected a company-specific education session would be provided in the next year, 36 percent did not expect such a session, and about 30 percent were unsure.

The trend is more pronounced in bigger companies. Nearly 45 percent of ACI Roundtable respondents whose companies had sales of more than \$1 billion said a “company-specific” educational session will be provided to the audit committee in the coming year.

The University of Memphis’s Abbott says a bigger issue than audit committee members reliance on the ACFE is the committee’s relationship with internal and external auditors. “Even the audit committee financial expert must rely on the internal and external auditors to perform their jobs,” he says.

At least one attorney whose firm works with audit committees begs to differ. Even if audit committee members satisfy the exchanges’ requirements while relying solely upon the ACFE, they may have violated fiduciary duties under certain state laws, according to Frederick D. Lipman, a partner with Blank Rome in Philadelphia.

The SEC has granted ACFEs a safe harbor, meaning that other committee members may not abdicate their responsibilities. In theory, the ACFE designation does not impose additional duties, obligations, or liabilities on the audit committee financial expert that are greater than those of other members of the committee.

And just what topics do committee members need to learn?

**While the definitions of financial literacy, financial expertise, and the ACFE vary, any audit committee that lacks the aptitude to question a public company’s financials might be in trouble.**

The University of Tennessee's Neel, a veteran of nine corporate boards, says committee members face a "tremendous challenge" in understanding the current financial climate. He is chairman of the governance committee for American Healthways Inc. and sits on Saks Inc.'s audit committee.

He feels strongly about one specific area of audit committee education—revenue recognition. And with the ever-changing economy moving from manufacturing to service industries, the rules have changed.

"A lot of industries have become far more complex," Neel says. "You have a real set of revenue recognition issues that differs from company to company. Service industries are becoming more difficult [to report]."

Under GAAP, it is generally thought that revenue should be reported in the financial statements when it is realized or earned at the point of delivery. Over the past couple of years, the Financial Accounting Standards Board (FASB) has determined that since no comprehensive standard on revenue recognition exists, there is a significant gap between the broad guidance in FASB's Concepts Statements and the detailed guidance in the authoritative accounting literature.

In the fourth quarter, FASB plans to issue an exposure draft on a revenue recognition general standard.

In December 2003 the SEC tried to fill the guidance gap by issuing Staff Account Bulletin (SAB) 104, which stated requirements for meeting criteria for a revenue recognition standard. It calls for four basic criteria: persuasive evidence that an arrangement exists, delivery has occurred, the vendor's fee is fixed or determinable, and collectibility is probable.

*Article written by Gary Larkin, Managing Editor, Audit Committee Insights.*

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## PERSONNEL

## Becoming a Committee Member Isn't What It Used to Be: KPMG's Audit Committee Institute

Now that the dust has settled from 2002's Sarbanes-Oxley Act (S-O), those with corporate governance responsibilities and nominating committees are facing the unexpected challenge of finding qualified audit committee members.

What it boils down to is a simple issue of supply and demand.

"There's obviously a large demand," says Julie Daum, North American leader of the board services practice for Chicago-based executive search firm Spencer Stuart. "It's not like last year, when boards said, 'Let's get a financial expert and we're done.' Most boards recognize it's not enough to have just one person who is financially savvy."

And search firms, among the more popular resources for audit committee recruitment, are turning to good old-fashioned networking to get the job done.

"We have a good relationship with the Big Four," Daum says. "We have a big, strong pool of CFO candidates. But it's really about getting out and getting to know the CFOs."

One of the reasons for the increased demand for audit committee members is that many financial experts already have outside committee assignments. "Most companies are restricting CFOs to serving on only one outside board," Daum says.

While Daum says that increased compensation could help lure quality directors, she doesn't think that money alone will entice candidates to accept an audit committee appointment. The increased compensation over the past two years reflects board recognition of the increased responsibilities, especially for audit committee chairmen.

According to a study of the top 200 public companies by compensation consultants Pearl Meyer & Partners, fees and retainers paid for audit committee chairmen increased 47 percent in 2003. On the whole, the average board compensation grew 13 percent to nearly \$176,000.

In addition to executive search firms, some boards use director registries offered by various groups or associations. The National Association of Corporate Directors runs such a directory from its Web site.

Those responsible for governance and audit committee members alike appreciate the difficulty of finding the right audit committee members.

Gail Deegan, a former CFO for Eastern Gas & Fuel in Boston, has served as chairman of Hopkington, Mass.-based EMC Corp.'s corporate governance and nominating committee since May. Although she has no audit committee vacancies, she admits filling a spot would be a daunting task right now.

"It [has] become more difficult to find people who have the skill set to be the [audit committee] financial expert, the time it takes to be on the audit committee and the willingness," says Deegan.

Gilbert Matsumoto, the audit committee chairman for Central Pacific Financial Corp. and its subsidiary Central Pacific Bank in Honolulu, knows about time constraints. "I was spending at



**The demand for available—and qualified—people to serve on audit committees far outstrips current supply.**

least four hours a month as a committee member in the past,” he says. “But presently as the chair, it’s at least eight hours a month and even more quarterly with having to review the 10-Q [filing] and the year end [financial statement].”

Identifying and recruiting the “right” individuals to serve on the audit committee is key to providing effective oversight over the financial reporting process, though ultimately, the board is responsible. In a July poll conducted by KPMG’s Audit Committee Institute (ACI), over 20 percent of respondents thought their boards of directors were not sufficiently engaged in considering their audit committee’s membership and effectiveness.

While financial literacy is important, it’s only one element to consider in evaluating audit committee candidates. Audit committee members must develop a deep understanding of the company’s business and related business and financial reporting risks to be effective, says Scott Reed, a partner with the ACI. In today’s environment with the increased expectations of audit committee members, it’s critical that each individual member be actively engaged in fulfilling his or her oversight role, Reed says.

A look at proxy statements by Spencer Stuart over the past two years shows that board and audit committee members are becoming more independent and committees are meeting more often. However, it also shows there were fewer new audit committee members named in 2004 compared with the huge spike in membership turnover in 2003.

According to the 2004 Spencer Stuart Board Index of Standard & Poor’s 500 corporations, the number of new or active retired CFOs accepting a new audit committee appointment has decreased. The index indicates that active or retired CFOs who were new audit committee members for an S&P 500 company fell to 36 from 61, year-over-year, and the percentage of total new members fell to 10 percent from 16 percent.

The decrease in CFO participation is indicative of the heavy workload and responsibilities those officers face in this business climate.

“It’s challenging for a current CFO to be an audit committee member on another board,” Deegan says. “Between the 10-Qs and the supporting schedules and the same year-ends, I have tremendous respect for the CFOs that are able to get all this work together.”

According to the SSBI, there are more retired chairmen, presidents, and CEOs sitting on audit committees, and fewer active ones. The percentage of retired officers rose to 26 percent from 20 percent and the percentage of active officers fell to 22 percent from 28 percent.

Turnover in the number of new audit committee chairmen subsided. In 2004 there were 37 new chairmen, while in 2003 there were 105.

The Spencer Stuart study also found that in the past year there has been a significant increase in the frequency of audit committee meetings. The number of such committees meeting between 8 and 10 times a year increased to 37 percent in 2004 from 27 percent in 2003. In addition, the number of committees meeting more than 14 times a year quadrupled to 40 in 2004, compared with 10 in 2003.

The amount of time needed for audit committees to oversee the reporting of a public company's financial statements as well as the internal and external audits prompts the question: Who wants this job?

That's where due diligence comes in.

"If I were a potential candidate now, I would definitely do my research," says Matsumoto, who was drafted as an audit committee member because of his CPA audit background. "The potential liability is too great. It is not only what you can bring to the company as to business, but you had better know what your responsibilities will be [as an audit committee member]."

Deegan looks at the process of vetting a prospective company as one would a relationship. She also serves on audit committees for EMC and TJX Cos. "When I joined EMC's board, I talked to almost every board member," she says. "I also talked to the CFO, the general counsel, and senior management." Many candidates are also asking to interview the independent auditor as they evaluate a potential audit committee position, according to the ACI.

But there was something even more important she considered. "What it comes down to is the honesty and integrity of senior management," she adds. "It's more than just looking at the financials, you've got to know the people."

*Article written by Gary Larkin, Managing Editor, Audit Committee Insights.*

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## PERSONNEL

# Message to Board: Find Out What's in Your D&O Policy Before It's Too Late

Not knowing the difference between a “severability clause” and a “final adjudication exclusion” could have major consequences for audit committee members and their fellow directors.

Board members who are ignorant of their directors and officers (D&O) liability insurance could end up exposed both legally and financially. What's more, audit committee members should review those policies—and know the details—before problems occur, not after.

Thanks to the onslaught of lawsuits related to corporate fraud and financial restatements, companies face higher premiums and need more coverage. In addition, employees engaged in questionable activities can siphon off the directors' insurance fund to pay legal costs.

“D&O policies are getting harder to come by,” says Melanie Damian, a principal in the Damian & Valori law firm in Miami, who works with audit committees. “It's getting more expensive, and what [policies] are covering is getting smaller and smaller. It's because of these corporate wrongdoings.”

Those wrongdoings have led to numerous shareholder class-action lawsuits, any one of which could exhaust a company's D&O insurance coverage. They include derivative suits filed by shareholders on behalf of the company against the board, Securities and Exchange Commission investigations, and the so-called “tag along” 401(k) Employee Retirement Income Security Act (ERISA) lawsuits.

A study by Milwaukee-based law firm Foley & Lardner shows that D&O insurance premiums for companies with annual revenue of \$1 billion or more was \$2.2 million in 2003. For companies with revenue less than \$1 billion, average D&O costs were \$850,000.

A company facing fraud charges along with a possible restatement of earnings can find itself short of coverage. Preparing for such a “doomsday” scenario is one factor that drives the amount of coverage a company seeks. Another is whether or not the company will (or can) indemnify a director in such a situation.

Many of these decisions begin with the size of the company.

“The market capitalization is the starting point,” says Gordon Davenport III, a partner with Foley & Lardner. “The biggest dollar exposure is market capitalization.”

From January 1, 1996, to September 27, 2005, there have been 2,087 federal class-action lawsuits filed against public companies, according to Greg J. Flood, COO of National Union Fire Insurance Co. of Pittsburgh, a subsidiary of AIG.

Flood, who spoke at a recent Directorship Search Group corporate governance forum in New York City, added that of those cases, only six have gone to trial. As of September 27, more than 1,000 had not been resolved. Those include litigation related to the mutual fund market timing scandals and investment banking research analyst conflicts of interest.

Just what should board members do when it comes to their D&O policy?

“I caution board members to get a little more involved,” said John Keogh, president and CEO of National Union. “You would think the head of the audit committee would want to meet with the insurance carrier.”

Keogh, who spoke at the recent Practising Law Institute corporate governance conference in New York, finds it hard to believe that directors are ignorant when it comes to their liability coverage, especially since they're on the firing line when it comes to shareholder litigation.

"We never meet them," Keogh said of board members. "We meet with someone from middle management in the company who deals with risk and insurance."

One audit committee chairman says his committee is briefed on the company's D&O policy by outside counsel once a year.

"When we have that legal briefing, we are asking, 'what is our specific coverage?' and 'how does it relate to the audit committee charter as well as the corporate charter [bylaws]?" says C. Warren Neel, audit committee chairman for Saks Inc.

Two issues that concern Neel, who is also executive director of the University of Tennessee's Corporate Governance Center, are possible changes in the business judgment rule for board members and the effects the Sarbanes-Oxley Act might have on liability.

Scott Reed, a partner with KPMG's Audit Committee Institute, says an informed audit committee member is a prepared one.

"Some of the best advice I have heard about D&O coverage is to make sure you know the type, amount, and exclusions included in your coverage and have someone on the outside who specializes in D&O help determine what's in and what's out," Reed says. "A number of audit committees have been seeking such advice from counsel with extensive experience in this area."

Damian and Davenport, who both specialize in D&O policies, believe the whole board should be involved in choosing the insurance carrier and types of coverage.

"The board is making that call," Davenport says. "Each of those directors will have a keen interest in the coverage and won't defer to just the audit committee."

Damian doesn't totally rule out committee responsibility on the matter. "The entire board should know what their D&O policy is," she says. "Is it appropriate for that responsibility to be given to the audit committee? Probably. But most boards today also have corporate governance committees that might be used."

Under many policies, claims based on fraud or dishonesty can be excluded from coverage. Perhaps the most prevalent type of exclusion calls for a lack of coverage if there is a "final adjudication," or court decision, that the alleged fraud did take place.

More than 90 percent of such lawsuits are settled out of court. However, since the language exists in the policy, many courts interpret it to mean that defendants in such lawsuits can put in claims for coverage up until there is a final adjudication.

The bottom line on the effectiveness of coverage is whether or not defense costs will be paid. "Sometimes plaintiffs will allege torts [a wrongful act that is not a crime or breach of contract], which could put you outside the coverage," Damian says. "Ultimately, you want defense costs to be covered by insurance."

**Industry observers find it hard to believe that directors are ignorant when it comes to their liability coverage, especially since directors are on the firing line when it comes to shareholder litigation.**

There are other clauses in D&O policies that board and audit committee members need to scrutinize as well, including severability, in which innocent directors and officers are better protected from losing coverage if an insurer receives inaccurate information about a company's financial condition that could lead to a restatement or is indicative of fraud.

"Severability is a real protection," Davenport says. Directors and officers have to make sure the severability clause specifies the policy cannot be rescinded for innocent directors.

"Some policies are going to cover [defense costs for] SEC investigations," Davenport says. "Sometimes directors can be squeezed out of coverage during a bankruptcy."

One option available for board members is excess coverage, which is taken out in addition to the traditional, company-provided coverage. A new, albeit expensive, alternative for audit committee members is an independent director liability (IDL) policy.

An IDL policy goes into effect following a triggering event, such as the rescission of the regular D&O policy or the rejection of a claim due to a restatement exclusion.

Usually, independent board members who sit on several boards and have large personal assets at stake use such policies. Some even use what are known as "portable" IDLs, which allow them one policy that covers their liability for all the boards they serve on, Davenport says. One problem there is that usually the board member has to foot the bill for the premium.

*Article written by Gary Larkin, Managing Editor, Audit Committee Insights.*

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## PERSONNEL

## Independent Audit Committee Could Be Proxy Target

As perhaps the most independent part of a corporate board of directors, the audit committee could be the most susceptible to the shareholder proxy access movement.

Audit committee members may not lose their seats tomorrow, but the rules that got them on the board are likely to change.

“This is going to happen one way or another,” says Nell Minow, editor of *The Corporate Library*, a corporate governance investment research firm. “There will be a fundamental change in the way directors are nominated.”

That change may come from powerful institutional shareholders, such as the American Federation of State, County and Municipal Employees (AFSCME) and the California Public Employee Retirement System (CalPERS), staging individual proxy battles. Changes could also come through proposed Securities and Exchange Commission rules to allow shareholders direct access to the nomination process.

For audit committee members, a big concern regarding shareholder proxy access is how the committee’s available talent pool might be affected.

The proposed changes create a host of questions for audit committees. One of the most vexing concerns is whether an audit committee will lose key people—such as audit committee financial experts—as shareholders assert themselves in proxies.

Scott A. Reed, a partner with KPMG’s Audit Committee Institute, says that it is very important that directors understand the process the nominating committee uses to identify potential board candidates. That process includes the steps taken to assess candidates’ independence, objectivity, and business savvy, as well as other specialized knowledge they might possess, he says.

“Identifying good audit committee members, especially those qualified to be designated as the audit committee financial expert, has been a challenge for some companies,” Reed says.

John Olson, a senior partner with the law firm of Gibson, Dunn & Crutcher in Los Angeles, believes institutional shareholder groups might target key audit committee members in “withhold votes” campaigns.

“An audit committee [could lose] a financial expert and have him replaced by a person who isn’t really qualified,” says Olson, who works in corporate transactions and securities. “You don’t see a lot of former audit people who want to be a dissident candidate.”

*The Corporate Library*’s Minow disagrees: “All the company has to say is this is our financial expert [in the proxy material],” she says. “This is the ‘shareholders are stupid’ argument.”

Minow argues instead that direct access to the proxy for shareholders could help rid the board of those members who aren’t up to snuff.

Under the SEC’s security holder director nomination rule (or shareholder access) proposal, companies would have to include in their proxy statements the names of shareholder nominees for the board under certain circumstances.



**The bottom line for shareholders is not getting a window into the boardroom, but a seat at the table.**

Two events would trigger such an action. One is if 35 percent of shareholders withhold their votes for a director who is up for election. (The threshold may be increased to 50 percent if and when the final rule is approved.) The second instance is if more than 1 percent of the shareholders can get half of shareholders to approve a shareholder director nomination process plan.

In the year since SEC Chairman William Donaldson proposed the shareholder access plan some institutional shareholders have put their nominees on boards.

Institutional shareholders have replaced directors on a case-by-case basis. Following the mutual fund market-timing revelations at Marsh & McLennan's Putnam Investments, the AFSCME Employees Pension Plan and other pension funds from California and New York elected their nominee to the board.

The pension funds came to a compromise with Marsh & McLennan, where they withdrew their proposal to allow shareholder director nominations in exchange for allowing Zachary W. Carter to be included on the management nominee slate.

"We moved directly to board engagement," says Richard C. Ferlauto, director of pension and benefit policy for AFSCME. "We ended up doing our own search process. We would come up with a half a dozen candidates."

"When there is a problem at a company that is [chronic] or a crisis, the shareholders should be able to intervene and replace board members," Ferlauto adds. As part of that process, he says, AFSCME will use an executive search firm to find suitable candidates.

When this type of communication is taking place between a board and a shareholder group, in most cases it is the nominating committee that is most heavily involved.

"The nominating committee process is the right thing," says Michael Mardy, audit committee chairman of Waltham, Mass.-based e-business and fulfillment service firm CMGI. "If you look at some nominating committees where somebody was asleep at the wheel, then you know what the committee was doing wasn't working."

The bottom line for shareholders is that they gain not only a window into the boardroom but also a seat at the table.

"That window may be oversold because of the fiduciary responsibility that board members would have," says Terry G. Christenberry, audit committee chairman of publicly traded Smithway Motor Xpress in Iowa and audit committee member of the private Broadview, Ill.-based funeral services company Wilbert Inc. "For them, it turns out to be handcuffs and not a magnifying glass."

Christenberry, who is cofounder of Kansas City investment bank Christenberry Collet & Co., explains that while a seat at the boardroom table might give insight into the board's decision-making process, it's no guarantee that the company's stock will perform any better. Since the board member would have a fiduciary responsibility to the company and the shareholders, that takes precedence over the price of the stock.

“I don’t necessarily think that it’s a bad thing,” Mardy says about shareholder nominees, “as long as the people who want a seat at the table are the people you want to see there.”

Mardy, who is also the CFO of South Plainfield, N.J.–based travel accessory maker Tumi Inc., acknowledged that most shareholder nominees are independent of the company, responsible, and ethical. But he does have a caveat for fellow audit committee members.

“When they are nominated to the board, there are two things you need to consider,” he says. “How are they going to represent their constituency [the nominating shareholder group] and the broad shareholders?”

What it comes down to, he says, is that an elected director needs to represent the two biggest parties—the company and the shareholders. “It’s not like an election for a board of education,” Mardy says.

*Article written by Gary Larkin, Managing Editor, Audit Committee Insights.*

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