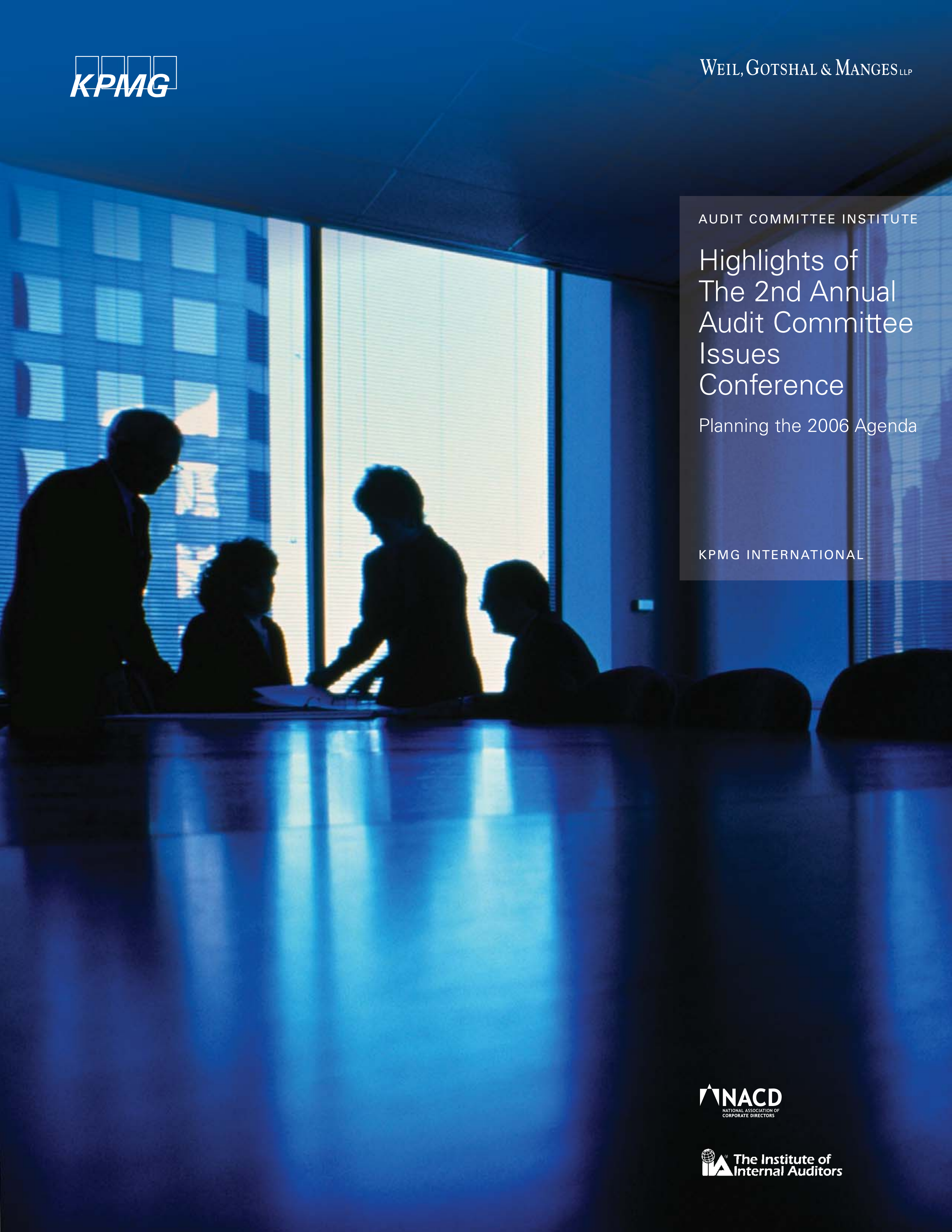

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Weil, Gotshal & Manges LLP

AUDIT COMMITTEE INSTITUTE

Highlights of The 2nd Annual Audit Committee Issues Conference

Planning the 2006 Agenda

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With Sarbanes-Oxley (S-O) and its section 404 compliance processes widely in place, many audit committees are refocusing their agendas to spend more time on issues and risks they believe are most critical to the integrity of the financial reporting process—from critical accounting judgments and estimates to internal audit resources to the alignment of strategy and risk. Given the demands of the new corporate governance environment, however, this "back to basics" focus presents its own challenges. The complexity of accounting issues, increased oversight responsibilities, and unprecedented expectations of shareholders and regulators require audit committee members to be more informed, engaged, and attuned than ever before.

2006 AGENDA PRIORITIES

Audit committee members surveyed during the conference identified three priorities for their 2006 agendas: (1) critical accounting policies, judgments, and estimates; (2) strategic risk; and (3) oversight of internal audit and internal controls.[1]

The 2nd Annual Audit Committee Issues Conference—hosted by KPMG's Audit Committee Institute with cosponsors Weil, Gotshal & Manges, the National Association of Corporate Directors, and The Institute of Internal Auditors—provided insights into the challenges, concerns, practices, and priorities shaping audit committee agendas for the year ahead.

Maintaining Constructive Relationships

Given the events of the past several years and the relatively new and still-evolving relationships within the financial reporting and corporate governance environments, maintaining positive and constructive relationships has proven challenging for many audit committees. Pressures and uncertainties related to S-O compliance and complex accounting standards as well as the audit committee's direct responsibility for oversight of the external auditor have, in many cases, strained key relationships.

RATING RELATIONSHIPS AND DYNAMICS

More than one third of audit committee members characterized their relationship with the external auditor as "somewhat effective but at times overly tense and strained." Approximately two thirds said the relationship and dynamics are "very effective," and that there is a "constructive tension."

To help ensure effective working relationships among the audit committee, external auditor, and management (including internal audit)—the "three-legged stool" of financial reporting oversight—audit committees are focusing on:

- Engaging in frequent, proactive, open communications and dialogue with the external auditor, senior management, and the internal auditor, including informal conversations outside of audit committee meetings
- Insisting on clear, timely, and thorough pre-meeting information and communications from management and auditors

1 All survey results are based on responses by audit committee members attending The 2nd Annual Audit Committee Issues Conference sessions in Palm Beach, Florida, and Phoenix, Arizona.

- Establishing clear expectations regarding roles and responsibilities, with a particular emphasis on the committee's direct responsibility for oversight of the external auditor
- Ensuring that audit committee meetings and executive sessions enable productive, candid, quality discussion of substantive issues
- Evaluating the effectiveness of internal and external auditors and identifying ways both might better support the audit committee
- Establishing a robust evaluation process to ensure the effectiveness of all participants—including the audit committee and internal and external auditors—and identify areas for improvement
- Ensuring a rigorous dialogue among the committee, management, and auditors on financial reporting issues and a "healthy skepticism" toward information presented.

Critical Accounting Policies, Judgments, and Estimates

The dramatic rise in the number of restatements over the past five years—including an estimated 1,200 restatements, or twofold increase, in 2005[2]—points to the challenging issues that audit committees must grapple with today: the increasing complexity of accounting standards, management's drive to "make its numbers," and high expectations of investors and regulators.

With continuing questions about "materiality" and interpretations and areas of gray as prevalent as black-and-white rules and calculations, the "right answer" can be highly subjective. Yet, a growing intolerance for accounting errors and "earnings management" has put a premium on the quality and rigor of the audit committee's oversight process. To help ensure the integrity and transparency of financial statements and disclosures, leading audit committees are making sure to:

- Ask probing, incisive questions, with a focus on recent changes in critical accounting judgments and estimates, significant variations from industry "norms," and alternatives and controversial issues discussed by auditors and management
- Consider the external auditor's view about the quality of accounting estimates and practices as applied in the company's financial reporting
- Understand the ramifications of alternative accounting treatments (related to material items) that the auditor has discussed with management as well as the auditor's preferred treatment
- Insist on the quality, clarity, candor, and timeliness of all communications from auditors and management
- Communicate expectations for transparency in all financial reporting and disclosures throughout the organization's practices and culture
- Provide educational opportunities for audit committee members to enhance their knowledge of financial statements, management's discussion and analysis (MD&A), and specific accounting policies, judgments, and estimates affecting the company and its industry.

DISCUSSING CRITICAL ACCOUNTING ISSUES

Approximately 35 percent of audit committee members surveyed said they needed to spend more time discussing management's critical accounting policies, judgments, and estimates.

2 *International Herald Tribune*, "Going Back After Enron: Lessons from Debacle Lost," Stephen Labaton, January 4, 2006, citing Glass Lewis & Co.

Crisis Management

Considering the significant legal, financial, and reputational risks that financial disclosure errors or abuses can have on a public company, audit committees are taking more time to consider the key processes and policies required to determine when and how to undertake an internal investigation.

A proactive approach and robust action plan can be invaluable in guiding the audit committee's investigation to a timely, credible, and conclusive result—particularly when faced with time pressures and a less-than-perfect understanding of the facts. To this end, audit committees are considering a variety of practices that can support a quality investigation, including:

- Employing outside experts, such as legal counsel and forensic accounting professionals
- Considering external auditor involvement, including determining what communications and updates may be appropriate or expected
- Managing the flow of information among the appropriate parties
- Making timely and accurate disclosures to regulators and others, as appropriate or required
- Documenting key processes, findings, and remedial actions taken (as recommended by legal counsel)
- Investigating the matter until the audit committee is fully satisfied that all relevant issues have been addressed.

Oversight of Risk Management

Oversight of risk management is an increasingly important priority and challenge for boards and audit committees. After the highly publicized corporate scandals of recent years—and the wave of corporate governance reforms that followed—investors, regulators, and rating agencies are demanding that companies have a comprehensive process for managing the major, and constantly changing, risks facing the enterprise. Audit committee knowledge about the processes used by management in identifying, assessing, and monitoring key risks—including financial, strategic, operational, reputational, and compliance—as well as the committee's role in ensuring the proper coordination of the board's oversight activities in this area, are vital elements of effective oversight.

To ensure effective oversight of risk management, many audit committees are focusing on understanding:

- The company's approach to risk management, including the processes it uses to identify, assess, and manage risks—both financial and non-financial
- Who is responsible for oversight of risk management, and how oversight responsibilities are coordinated among the various board committees
- The audit committee's risk oversight responsibilities from a regulatory perspective (including NYSE requirements), and how it is discharging those duties
- The company's current risk profile and risk "appetite"
- The alignment of the company's risk management process and business strategy.

RESPONSIBILITY FOR INTERNAL INVESTIGATIONS

Approximately 65 percent of survey respondents said the board or audit committee (as opposed to a member of management) is primarily responsible for determining whether to launch an independent internal investigation into allegations of corporate misconduct.

WILLINGNESS TO JOIN AN AUDIT COMMITTEE

Despite prevailing views in the legal community that the legal standards governing board director fiduciary responsibilities have not changed, more than one third of audit committee members said they are "somewhat less willing to accept new audit committee appointments" as a result of Sarbanes-Oxley and related corporate governance reforms.

LINKING STRATEGY AND RISK

Nearly 80 percent of audit committee members said they were only somewhat satisfied with or needed to improve their understanding of the company's strategy and processes used to manage the risks associated with that strategy.

GREATEST RISKS TO SHAREHOLDER VALUE

From 1998 to 2003, more shareholder value was lost because of strategic or operational failures (87 percent) than compliance failures (13 percent).[3]

3 *Shareholder Value Destruction Study*, Booz Allen Hamilton, 2004.

2006 AGENDAS ON TARGET?

Only 45 percent of audit committee members said they are "very satisfied" that their 2006 agenda appropriately addresses the current issues that require the committee's attention and oversight.

Agenda Setting

The audit committee's performance in overseeing the host of challenges, opportunities, and risks facing companies today is largely driven by its agenda. As the touchstone for audit committee activities, both at audit committee meetings and during the year, the agenda and agenda-setting process determine where and how the audit committee spends its time and attention. It also communicates the audit committee's priorities and expectations to management, auditors, regulators—and, potentially, shareholders and the marketplace.

While agendas should be tailored to an audit committee's own needs, objectives, and responsibilities, many audit committees are developing agendas that help ensure:

- The audit committee's activities align with its charter
- Sufficient time is provided for the consideration and questioning of substantive issues
- An appropriate flow of information and frequency of communications
- The consistency and alignment of key financial reporting factors, including culture, tone at the top, audit and accounting approach, financial disclosures, management incentive compensation, risk management, and corporate strategy[4]
- Opportunities for periodic self-evaluation and ongoing education.

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For more information about the Annual Audit Committee Issues Conference, please visit www.kpmg.com/aci or contact the Audit Committee Institute at auditcommittee@kpmg.com or 1-877-KPMG-ACI.

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4 "Six Priorities for Boards in 2006," Weil Briefing: Corporate Governance, January 2006, Weil, Gotshal & Manges LLP.